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Globalism vs. Nationalism

Course Guidebook

Professor Ramon P. DeGennaro
The University of Tennessee
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Ramon P. DeGennaro, Ph.D.

Haslam College of Business Professor in Banking and Finance
The University of Tennessee, Knoxville

Ramon P. DeGennaro is the Haslam College of Business Professor in Banking and Finance at The University of Tennessee, Knoxville. He has also served as a visiting scholar at the Federal Reserve Banks of Cleveland and Atlanta and for the American Institute for Economic Research. Professor DeGennaro holds a B.S. in Education from The Ohio State University, an M.Ed. from Ohio University, and a Ph.D. in Finance from The Ohio State University.

Professor DeGennaro's research involves investments, financial markets, and political economy. He has published more than 45 refereed articles on investments, financial market volatility, small-firm finance, the term structure of interest rates, financial institutions, and prediction markets. He has also written research reports, book chapters, book reviews, and several Federal Reserve publications.

At The University of Tennessee, Professor DeGennaro has been nominated for the Allen H. Keally Outstanding Teacher Award, the John B. Ross Outstanding Teaching Award (3 times), and the College of Business Outstanding Teaching Award.

Professor DeGennaro has presented original research at dozens of professional conferences, and he is the recipient of more than 60 research and professional development grants. In addition, he consults in the areas of business valuation, investments, and financial management and is a luminary member of the Angel Capital Group.

Professor DeGennaro's other Great Course is *How the Stock Market Works*. ■

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SCOPE

For the first time in human history, products, services, technology, money, and information flow virtually unimpeded throughout the world. Modern commerce is global.

International economic organizations—the World Trade Organization, the International Monetary Fund, the World Bank, and other bodies—play a large role in global commerce. Those are examples of institutions with a physical presence. They're comprised of men and women working mostly toward a common set of goals, and in these cases, they even have buildings and budgets.

A physical presence isn't necessary for an institution to affect our freedom and prosperity, though. An institution could also be a custom or law that many people use or follow. An example is democracy. Another is property rights: the right to own property, and to use it the way you want. Institutions are also the formal and informal rules that govern economic and political life.

This course covers the activities and rules set by international economic and political organizations and the often-controversial roles they play in civil society. We begin with an analysis of the

reasons why some nations are rich while others are poor. We'll continue by examining why nations work through international institutions, exploring the role of central banks, and looking at different government and economic systems. We'll take a look at group choices and how the rules we choose to govern our cooperation determine their outcomes.

Next, we'll turn to the political and economic causes of the Great Depression; the growth of international political and economic institutions that formed during the 1930s and 1940; and the International Monetary Fund and the World Bank—the institutions that sprang from the intrigue of the famous Bretton Woods Conference in 1944.

We'll learn the different institutions that politicians and economists have used to manage international trade, including monetary arrangements to manage currency exchange rates. We'll see that most managed systems eventually break down.

We'll examine the politics that drove the formation of the European Union. Then, we'll look at its goals and growth, culminating in Brexit, the United Kingdom's withdrawal from the European Union. We'll also explore the implications of the huge bureaucracies these institutions have become, and learn how they have expanded their missions to include human health and safety, environmental protection, climate change, food safety, workers' rights, and human rights.

Nations value international cooperation, and institutions help them achieve that. Yet, domestic politics always trumps international cooperation. The first order of business for policymakers is to remain in power. Elected officials want to be reelected, and dictators must prevent rebellions and coups. This means that domestic constituents steer a nation's behavior within international economic institutions. Economics informs the discussion by explaining what will happen if political entities take a certain action, but politics presses the buttons to take that action.

We'll also learn about the G groups, such as the G7 or the G20, which are informal groups of nations that have no headquarters or permanent staff. They meet when and where they choose to meet, and discuss whatever they choose to discuss. They are political organizations that seem designed to provide little more than choreographed pageantry, yet which do their more important work during economic crises.

Strong institutions providing structure to society hold promise. These include economic and political freedom; decentralized power; restrictions on violence; the rule of law; and property rights. History shows that countries that feature these strong institutions are far more prosperous than those that don't. That won't be changing anytime soon. ■

LECTURE 1

THE POLITICS OF ECONOMIC INSTITUTIONS

In the book *Why Nations Fail*, MIT economist Daron Acemoglu and Harvard political scientist James Robinson try to explain why nations' fortunes vary. We live in a very integrated world. We enjoy the lowest real transportation and communication costs in history. Yet many nations have made scant progress, and the gap between rich and poor nations has grown. Acemoglu and Robinson point out that the gap today between rich nations and poor nations is far larger than it was in 1776, when Adam Smith wrote *The Wealth of Nations.* The question is: Why?

Incomplete Reasons for Gaps

- Rich nations are perhaps 20 or 40 times richer than the poor, compared to a factor of 4 or 5 in Adam Smith's day. We have many explanations of why some countries are rich and some are poor. Poor countries in Central America and sub-Saharan Africa typically lack well-functioning markets, their human capital is low, and their physical capital stock is obsolete or badly maintained.

- But this begs the question of why these places don't have better markets, better human capital, and better physical capital.

- Among the first explanations for why some nations are poor is that they lack natural resources. This explanation is losing ground for at least 2 reasons. First, the world has too many countries like Nigeria, which is blessed with massive oil reserves and good ports, but are nevertheless poor, with living standards among the lowest in the world.

- The second reason is economic growth. Poor countries aren't just poorer than other countries. They don't grow as fast, either. They tend to stay poor in an absolute sense. Natural resources can't explain that.

- Culture is another popular explanation of why some nations are richer than others. But this doesn't work if we look at countries through time. For example, China faced famine and poverty under Mao, while people with the same culture in Hong Kong were doing just fine. When the incentives in China improved, the country's growth was explosive, and China now ranks as the second-largest economy in the world.

- Economist Craig Richardson has produced some fascinating work on Zimbabwe. Richardson developed images of Zimbabwe using Google Earth before and after the dictator Robert Mugabe's land grab, beginning around the year 2000.

- The images show a dramatic difference between communal farmland and private farmland. The official explanation is a drought on the communal side. Yet droughts don't follow straight lines along borders very often. A better explanation is that when people own property, they are willing to invest to improve it.

- The private property has dots of blue, which are reservoirs and artificial lakes for irrigation. About 4 years after the land grab, the communal property continued to deteriorate, but the formerly private land suffered more. The blue lakes and reservoirs there were gone. Government policies like this are not born of ignorance. They are by design.

- So, if it's not geography, or culture, or ignorance, then why are nations poor? Many people believe that free markets help to promote prosperity—along with private property rights. But those factors alone don't seem to be enough.

- After the collapse of the Soviet Union, for example, the obvious prescription for growth seemed to be to get state-owned assets back into private hands. And that was absolutely right. The problem was that political institutions that limit cronyism must support free markets and property rights. Adding privatization to a dysfunctional economy like the former Soviet Union just gave powerful elites the chance to grab state assets cheaply.

Political Institutions

- Acemoglu and Robinson say that political institutions are the fundamental drivers of prosperity. Their definition of *institution* is "the formal and informal rules that govern economic and political life."

- They use the term *institutions* quite broadly. Institutions are more than formal rules and legislation. They are also societal norms and customs. That's important: Lots of countries have great social institutions and written constitutions, but their leaders ignore the laws if they find them to be inconvenient.

- An important concept when it comes to institutions is the rule of law, as opposed to the rule of men. Somewhat loosely, the rule of law has several parts:

1. No extraordinary processes. That means that everyone is subject to the same procedures in court.
2. Judges must be chosen in a way so that they are most likely to be impartial.
3. A person must be told of the offense they are charged with committing.
4. A person has the right to be heard.
5. Some would add that you can't impose restrictions on one class that you don't impose on another. That has fallen by the wayside in the United States

- Nicholas Vincent, a professor of Medieval History at Britain's University of East Anglia, points to the Magna Carta—signed by King John of England at Runnymede in June 1215—as pathbreaking because the law applied to the king as well as to everyone else. If a "regular" person goes to jail for violating a law, then so does the king or other important political figures. This was a breakthrough in the principles of freedom.

> *Adding privatization to a dysfunctional economy like the former Soviet Union just gave powerful elites the chance to grab state assets cheaply.*

- Another institution is the mechanism to distribute political power. Think of the checks and balances envisioned by the founders of America as compared to the totalitarian regimes of the Soviet Union's Joseph Stalin or Japan's Emperor Hirohito.

- According to Acemoglu and Robinson, we can divide institutions into 2 types: inclusive institutions and extractive institutions. Inclusive institutions level the playing field, distributing power broadly throughout society. In contrast, extractive institutions are designed to transfer wealth from the masses to the elites.

- Acemoglu and Robinson contend that good institutions have 3 important characteristics:

    1. Strong property rights, so that people have incentives to invest and innovate.
    2. Limits on elites, politicians, and other powerful interest groups, so that they can't extract the resources belonging to the less powerful, or tilt the playing field.
    3. A measure of equal opportunity.

Prosperity

- Sadly, many nations throughout history have applied the rule of law selectively. The vast majority of the world's population has few property rights, and limits on the political and economic power of elites are increasingly hard to see in many countries.

- This matters for economic development. If you search for a map of the world—colored for various income levels—you'll find the usual suspects at the high end: North America, Europe, Australia, and New Zealand. Most of Central Africa and parts of Central and South America are the poorest. You'll find a fairly strong correspondence between prosperity and property rights.

- A search for economic freedom will tell much the same story, with the notable exceptions of the United States and Canada, which in recent years have steadily fallen in the rankings and now rank only as "mostly free." Economic freedom is correlated with prosperity.

- Note: Correlation does not imply causation. Acemoglu and Robinson need a situation in which economic and political institutions change—for reasons unrelated to other things that might affect prosperity—to make the case that economic institutions are a big factor in prosperity.

- The European colonization of the Americas and other regions beginning in the 15th century is a good place to start. Colonization remade the existing institutions in colonized regions, but had little or no effect on climate or other geographic features.

- If natural resources were the basis for prosperity, then colonization shouldn't make much of a difference. But if institutions are the key to prosperity, then countries that experience institutional change should see noticeable welfare changes, and those changes should depend on the nature of those institutional changes.

Sadly, many nations throughout history have applied the rule of law selectively.

- Acemoglu and Robinson found that the institutions hypothesis fits the data quite well. European colonists held the political power, so they were able to impose their choice of institutions on the natives. If there was a large native population that they could subjugate and force to work, then they didn't need to settle large populations from their homelands. The goal was to extract the gold or other riches and be done with it.

- Extractive institutions are effective at that. In what is now Peru, for example, even before the 1500s, the region had a large population with a centralized government that already had extractive features. People worked in large part for the benefit of the rulers.

- The 16th-century Spanish colonial leader Francisco de Toledo found that situation ideal for exploitation. The Incas already had a long tradition of forced labor. De Toledo, holding the whip hand because of his military firepower, required one seventh of all males in an enormous area—including most of what is now Bolivia, and extending north to the middle of what is now Peru—to work in mines and on plantations.

- That extractive system lasted until 1825. That's a long time to do without the freedom to market your labor in the way you see fit. By then, those areas were way behind their contemporaries in North America.

- Some of the most horrible situations were found in the Caribbean. Belgian colonialists established plantations worked by slaves. Central American mines used forced labor. Such systems can't function if the masses hold political power, and if people have the economic freedom to work in the manner they choose. Instead, extractive institutions were ingrained into Caribbean society.

Population distribution is one reason why Europeans introduced extractive institutions in some regions and inclusive ones in others.

- By comparison, in colonies with few natural resources to extract—with vast tracts of thinly populated land—Europeans themselves settled in large numbers. They traced their ancestry to lands like England, with laws and institutions to protect basic political and economic rights.

- Why did the Europeans introduce extractive institutions in some colonies and inclusive institutions in others? Some geographic features are more suitable for coercive institutions. For example, the warm, wet climate and type of soil in parts of the Caribbean are great for growing sugar. That's conducive to plantations; for those in power, oppressive social systems and even slavery become options.

- Population distribution is another reason why Europeans introduced extractive institutions in some regions and inclusive ones in others. Nomads, for example, are hard to enslave because they can just migrate to another area and they aren't used to taking orders from overlords.

Economic Freedom

- The economist David Henderson—in a review of the book *Why Nations Fail*—asks why North America was freer than Central and South America in colonial times.

- The answer is that the English—partly because they were not the first to the colonial party—wound up with the leftovers. The Spanish and Portuguese had already laid claims in Latin America, with rich loads of precious metals.

- North America had no such easy sources of gold or silver, and the northern parts—particularly what is now Canada—had a harsh climate that wasn't conducive to crops. To attract settlers and keep them fed, they had to be granted private property, relatively little centralized power, and much freer labor markets.

- Still another reason is that most of the Spaniards' gains went to the crown. South Americans dug the gold from their homelands' mines, but it went to Europe. Why would the natives work hard under such a system? The answer is they didn't.

- The English weren't smarter or nicer in the New World. Rather, the English gave servants and immigrants political rights to motivate them to work the land. Political rights coupled with economic rights led to such growth that North America outstripped South America. Acemoglu and Robinson argue that inclusive institutions were the difference.

The Headright System

- Most historians would call the headright system—which began in 1618, in Jamestown, Virginia—an extractive system. Anyone who settled in Virginia, or paid the travel expenses of another person who settled in Virginia, got 50 acres of land for each immigrant under the headright system.

Concentrating land ownership doesn't necessarily create a class of power elites, but it does go a long way toward accomplishing that.

- Europeans had developed a great fondness for tobacco, and Virginia had areas that were perfect for that. At the time, there simply weren't enough people to work the tobacco farms. The headright system was one way to get people there to work.
- Slaves and indentured servants counted under this system. At least several hundred slaves were introduced to the colonies this way—and that doesn't include the human costs of those who didn't survive the trip.
- Nobody thinks that slavery is an inclusive institution, and headrights concentrated property ownership in the hands of those who could fund the new immigrants.

Central Government

- Economic historians take issue with Acemoglu and Robinson on the role of the central government. It's absolutely true that someone has to maintain order so that private ownership is respected. Acemoglu and Robinson say that only a strong central government can provide the necessary order.

- Scholars such as the economist David Henderson take issue with that. Henderson thinks that the authority to maintain order and enforce contracts and the law more rightly resides with a local or municipal government, for example, instead of a state or federal government.

- Henderson points to economic development after the Roman Empire began to fade from the scene. He says that many European cities "were outside the sphere of influence of monarchs and aristocrats." The cities that maintained order and enforced the law to go along with inclusive institutions did fine despite that.

- Details aside, though, Acemoglu and Robinson's major point holds. Institutions are a key factor in why some nations succeed while others fail.

Suggested Reading

Acemoglu and Robinson, *Why Nations Fail*.

De Soto, *The Other Path*.

———, *The Mystery of Capital*.

Scott, *Seeing Like a State*.

Questions to Consider

1. What is an institution?
2. What role do institutions play in prosperity?

LECTURE 2

FINANCIAL REGULATION ACROSS BORDERS

International economic institutions are more than just buildings. Eric J. Pan—the director of the Office of International Affairs at the US Commodity Futures Trading Commission (CFTC)—points out that the word *institutions* also means the links between them. We might add that institutions necessarily include the people who work inside of the buildings. Think of institutions as families: In a family, the parents set the rules and have the power to enforce them. But different families have different rules, much the same way different countries (and institutions) have different rules. What happens when these differences intersect?

Architecture

- Eric Pan uses the term *international financial architecture* to describe large institutions (and the linkages between them). He says that any international financial architecture needs an administrative organization with the resources, independence, and authority to handle the big job of supervising international institutions.

- In turn, David Zaring—an associate professor of legal studies and business ethics at the Wharton School of Business—asks, “How does this system work?” Most of the time, it does OK. But Zaring calls the system “mostly ineffective” during the financial crisis of 2007–2008.

- Zaring points out that during the crisis, high-level government figures found the need to engender regulatory cooperation among states. He says that “state-centric forums,” such as the Group of 20 (G20), were more effective than international regulatory organizations.

- The G20 is an international forum that brings together governmental leaders and central bank governors of 20 large economies, including the US, Australia, Brazil, China, and the European Union.

- Part of the underlying difficulty is in getting the leaders of different nations (that is, the heads of state who attend the G20 meetings) to agree on what needs attention at the lower levels of financial regulation. A bigger problem yet is getting state leaders to agree on a solution.

Rules and Enforcement

- Before the financial markets crisis, legal scholars concentrated on making sure that the rules of accounting and economics were relatively consistent across countries. That’s important. But if you’re worried about the collapse of international institutions during a crisis, then supervision of international institutions is important, too.

- Who’s going to be responsible for that? And how do you make sure that whoever is responsible has the authority to make its decisions stick? If an answer exists, it’s not obvious.

- Near the height of the financial markets crisis, the G20 leaders pledged in November 2008 "to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances." Of course, saying so doesn't necessarily make it so.

- Eric Pan says the transgovernmental networks existing today are useful in building consensus among regulators. But he argues that we need more. We need an international legal framework. The current system is good for learning what to do. It's not so good for ensuring that international institutions actually do it.

Types of Institutions

- The different types of international institutions (and powers) can be confusing. This course will focus on 3 categories:

  1. International organizations. These are big, visible institutions like the International Monetary Fund (IMF) and the World Bank.
  2. State-to-state contact groups. The G20 and other G groups are among these.
  3. Transgovernmental networks. Think of the Basel Committee on Banking Supervision and the Financial Stability Board.

- In 1944, at the height of World War II, representatives of most of the allied economic powers met in Bretton Woods, New Hampshire. Bretton Woods gave birth to 2 major international organizations that extended the idea of big government to the international economy.

- These were the IMF and the World Bank, which in 1947 would be joined by the General Agreement on Tariffs and

Trade (GATT), the latter of which would eventually spawn the World Trade Organization.

Governments employ private investment services, hire private law firms, sell to private investors, and get rated by private entities.

- These are massive institutions, with huge budgets, high visibility, and large numbers of skilled employees. Even so, Wharton's David Zaring says they lack sufficient expertise, and the legal authority, to supervise international economic institutions.

- How is this possible? The political scientist Orin Kirshner notes "the IMF, the World Bank, and the GATT were created to address the global problems of the 1920s and 1930s, not the problems we face today."

- And international financial markets are, today, private markets. Some would disagree with this, but if you do, consider the size of corporate financial activity and the role private firms and individuals play in how governments manage and sell their debt.

- Governments employ private investment services, hire private law firms, sell to private investors, and get rated by private entities. As a result, the question of whether—and how—to regulate international transactions by private firms and persons has come to the fore.

Authority

- Eric Pan claims that the IMF, the World Bank, and the World Trade Organization are each missing something critical to be effective financial regulators and supervisors.

- The IMF and World Bank might have the necessary skills and resources to supervise and regulate international economic

institutions, Pan says, but they come up short in legal expertise. In turn, the World Trade Organization probably can drum up enough legal authority to do the job—but it lacks the necessary technical skills.

- So, why not just plug the holes and move on? That can't work. All 3 of these institutions are bound by inflexible treaties and by the authorities that govern them. For example, Article IV of the IMF Articles of Agreement doesn't allow it to conduct surveillance of private businesses.

- And because these organizations can't just expand their authority—to start making rules and supervising private markets—Article IV rules out the IMF as a bank supervisor.

State-To-State Contact Groups

- What about state-to-state contact groups? An example of these are the G groups, such as the G20. The G groups have no stated mission and their decisions are merely political statements and not legally binding.

- But when representatives of economically powerful countries talk, people listen. For example, regulators closed a not-very-important bank in Germany called Bankhaus Herstatt one day in 1974. Herstatt's foreign-exchange creditors simply didn't get paid. But suddenly, banks didn't want to make payments on foreign-exchange payments—because they weren't sure they would get paid in return. The market froze.

- The G10 responded by setting up the Basel Committee on Banking Supervision. Its first orders of business were to open lines of communication between

> *Transgovernmental networks are important because the world continues to become increasingly interdependent.*

the bank regulators in member countries and to develop guidelines for handling banking crises.

- These state-to-state bodies set the policy agenda while informal regulatory networks—like the Basel Committee—do the actual work.

Transgovernmental Networks

- Anne-Marie Slaughter, the president of the New America research institution, and Wharton's David Zaring define transgovernmental networks as links between sub-state actors. Such links—regulators, for example—let officials work directly with their foreign counterparts.

- In turn, senior state administrators mostly stay out of the way and let them work. This is increasingly important as the world grows increasingly interdependent. Transgovernmental networks are the primary vehicle for regulatory cooperation. They develop, or at least should develop, expertise that others simply don't have.

- Older approaches are either incomplete or fail completely. Environmental regulation is a classic example: Taller smokestacks used to be thought of as good because they send pollution far from the source, but the result is that it lands on someone else.

- Here are 2 noteworthy examples of economic regulatory transgovernmental networks.

    1. The Basel Committee on Banking Supervision. This comprises representatives of central banks of about 25 countries and meets fairly regularly with the goal of improving banking supervision. It is run by consensus. Basel doesn't have formal legal powers. Still, Basel's

recommendations have been adopted by bank regulators worldwide.

2. The Financial Stability Forum, which in 2009 expanded to include more than 50 regulatory agencies from about 25 countries, plus another dozen international agencies. The Financial Stability Board (FSB), as it is now known, brings these agencies together to design measures to promote international financial stability. The FSB doesn't have formal legal powers. Instead, it holds influence based on its regulatory expertise.

- Transgovernmental networks do a pretty decent job of rulemaking these days. The Basel I and Basel II recommendations on banking laws and regulation in recent decades have flaws. But, for the most part, they represent examples of broadly accepted sets of regulatory standards for insurance, securities trading, and especially banking.

Modern Supervisors

- Even so, the 2007–2008 financial crisis revealed that something very important was still missing. That is, there were lapses in supervision—the framework for making sure that institutions follow sound business principles.

- Rules and standards are meaningless without supervision and enforcement. But skilled supervisors are a scarce commodity in the best of times. The rapid pace of technological change and internationalization mean that the requirements for supervisors are more demanding now than ever before.

- Andrew Crockett, a former general manager at the Bank for International Settlements, says that supervisors are becoming more like consultants. Good supervisors don't always have an adversarial relationship with the

Supervisors must identify risks that an institution's management might have missed.

management of the institutions they supervise. In principle, they share a common goal: safety and soundness.

- One problem: Who knows how a bank manages its risk better than bank employees? And who, all else equal, would make the best supervisor? It's the same person. Under the circumstances, a revolving door, with banks hiring former regulators, and regulators being former bank employees, is both normal and a potentially serious problem rife with conflicts of interest.

- Supervisors have to question the internal decision making and risk management of institutions even if bank executives haven't done anything that clearly violates a rule. That's harder if you used to work for the people you're supposed to be investigating and whom you count as friends.

The Ultimate Supervisor

- One final problem is: Who should be the ultimate bank supervisor? Should it be an international agency? Should

it be the home country, like the United States for Bank of America? Or should it be the host country—like Japan for the Japanese branches of Bank of America?

The architecture of international financial regulation remains under construction.

- Nobody's found the perfect solution. The Basel Concordat decided that the least bad solution is "consolidated home country supervision." That means that the primary supervisory responsibility for an international financial institution is the institution's home regulator. That's the US Office of the Comptroller of the Currency, in the example of Bank of America.

- But in times of stress, home-country supervision can be a problem. Financial assets are fungible. If the Japanese branch of a US institution gets in trouble, it's very easy to shift the remaining good assets from the troubled bank out of the host country (Japan, in this instance) and back to the home country (the United States).

- U.K. regulators found themselves in this position in October of 2008. The Icelandic banking crisis was the largest in history, relative to the size of Iceland's economy. The Icelandic Financial Supervisory Authority, or IFSA, had responsibility for supervising the Icelandic banks and their foreign branches, including those in the United Kingdom.

- When problems surfaced, U.K. politicians and regulators challenged the competence of the Icelandic Financial Supervisory Authority, and demanded a role in resolving the crisis. They were too late. They eventually lost in court, too.

- As a result, U.K. and Netherlands taxpayers lost about 4 billion euros. Clearly, the architecture of international financial regulation remains under construction.

Suggested Reading

Beetham, *Max Weber and the Theory of Modern Politics*.

Call and Barnett, "Looking for a Few Good Cops."

The Economist, "Cracks in the Crust." Viewed at http://www.economist.com/node/12762027.

Financial Stability Board, "About the FSB." Viewed at http://www.fsb.org/about/.

Questions to Consider

1. Who or what should supervise international financial institutions?
2. How do policy makers make sure that supervisors of international financial institutions have the authority to enforce their decisions?

LECTURE 3

INTERNATIONAL ANARCHY UNDER ONE ROOF

The American political scientist Kenneth Waltz helped to teach political scientists to think of world politics the way economists think of markets in his book, *Theory of International Politics*. Waltz's theory of international organizations states that organizations arise because they are efficient solutions to market imperfections. But George Washington University professors Michael N. Barnett and Martha Finnemore say the organizations' behavior doesn't follow that script, and often doesn't do what the states that created them intended them to. Instead, they often act autonomously, in ways unintended and unanticipated when created.

The Ends and the Means

- International organizations' rules can make them inflexible and ill suited for changes in their environments. Like any bureaucracy, the mission can get buried under the institution's own rules. That, in turn, Barnett and Finnemore say, can lead to inefficient and even self-defeating behavior.

The economist Ronald Coase argued that organizations are efficient solutions to contracting problems, incomplete information, and other market imperfections.

- In such cases, following the rules becomes the end rather than the means. The social theorist David Beetham says that bureaucracies often define their missions to fit the most comfortable rulebook.

- Here's a great example from James Ferguson, the chairman of Stanford University's Anthropology Department. Suppose you're the World Bank, and you need to decide which development goals you need to pursue. How would you proceed?

- The World Bank picked a method that makes no sense—according to Ferguson—unless you're part of a bureaucracy.

Instead of choosing a goal and then collecting the data necessary to complete it, the World Bank decided to use existing data-collection procedures and chose its goals using only that data.

Goals

- Although international organizations exist to advance states' interests, it's a mistake to assume that international economic institutions are passive channels, according to Barnett and Finnemore. Instead, they say, once they are up and running, international economic institutions can develop agendas of their own.

- For example, Temple University political scientist Mark Pollack says that *eurocrats*—a term sometimes used to describe the roles of bureaucrats who administer the European Union—have carved out their own independent roles in the bureaucracy.

- You can think of states as principals and international economic institutions as their agents who are charged with some task. Standard principal-agent problems will arise in that case. States can't monitor their agents without spending time and money, and it costs too much to eliminate shirking and to force total compliance with the stated agenda. Just like in any other principal-agent arrangement, you'll find some residual problems, including unintended independence.

States can't monitor their agents without spending time and money.

- Barnett and Finnemore say that international organizations and international economic institutions can become independent from the principals—the states—that authorized their existence because they derive power from 2 sources:

1. They control technical expertise and information.
2. Like any bureaucracy, they have some measure of legitimacy because they are derived from the state's authority.

- Bureaucracies have to have rules to guard against individuals making mistakes. Sometimes, though, bureaucrats bend the rules. This can make perfect sense in any particular case. The danger is that the deviation becomes the new policy and that future employees won't even realize that the new policy isn't the original policy, or perhaps won't be aware of the danger that the original policy was designed to prevent.

Definitions

- International organizations and international economic institutions get enormous power from their ability to classify objects, according to political science experts Tom Weiss and Amir Pasic. They can even change the definition of words, such as *refugee*.

- Most of us have a fairly good idea of what makes a refugee. But according to Weiss and Pasic, that's not good enough for the United Nations High Commission on Refugees. They decide who gets the aid they have to distribute.

- Are refugees "temporarily" and "involuntarily" living outside their home country, or do permanent exiles count, too? Would you call an economic migrant or guest worker a refugee? Some of these are life-or-death decisions. If you're put in the favored class, then you live. If not, then the United Nations High Commission has no authority over your fate.

- The definition of *security* has also changed, according to Barnett and Finnemore. It used to more or less mean, "No invading armies," or at least, "limited violence." Now, it also includes humanitarian issues, including poverty and

the environment. This contributes to mission creep and introduces new actors to the stage. In a war, the actors are soldiers, but in a natural disaster, the actors might include relief workers with much different skills than soldiers.

Evaluation

- How do you evaluate an international economic institution? Some organizations are easy to evaluate because they have unambiguous, observable criteria for success: Did your team win the football game? Did your company hit its earnings target? These cases are easy.

- Others, like a university, have much more nebulous missions with murky definitions of success. These institutions are more insulated from competition. A small, private college might shutter its doors, yes, but a large, public institution doesn't worry about that. Because competitive pressures are lower, poor performance can persist for longer than it would otherwise.

- Roland Paris, an associate professor at the University of Ottawa, says that the UN and other international organizations place too much emphasis on holding elections as a measure of success. Paris points to Bosnia as an example. The UN, along with NATO forces led by the United States, stepped in to stop the brutal extermination of Bosnian Muslims at the hands of Serbs.

- After the fighting slowed, the UN conducted elections. Paris says these elections were held way too soon. What was the result? According to Paris, the Bosnia elections ratified what UN had intervened to prevent in the first place: ethnic cleansing. The wrong evaluation criterion led to a bad outcome.

- International organizations react differently to feedback about their work. Institutions that lack supervision, or which are insulated from competition, often end up promoting goals that don't align with the entity they are supposed to serve.

Importance

- Do international institutions even matter, and if so, then why? Let's start with an example from Daniel Kono, an assistant professor of political science at the University of California, Davis.

- In March 2002, the Bush administration levied a 30% tariff on steel imported to the United States. The administration justified the tariff because it was an emergency, claiming that imports had jumped dramatically.

- The country's trading partners didn't think that constituted an emergency and responded immediately. They condemned the tariffs as a violation of World Trade Organization rules, and filed a dispute settlement with the WTO. The United States lost.

Institutions that lack supervision often end up promoting goals that don't align with the entity they are supposed to serve.

- In November 2003, the United States lost on appeal, and the WTO ruled the tariffs illegal. The European Union, Japan, and China announced that they planned to levy retaliatory sanctions if the United States did not comply with the WTO's ruling.

- One month later, the United States did. So, what caused the United States to drop the tariff? Kono has 3 competing possible answers:

1. The United States felt legally bound by the WTO's decision.
2. The WTO made no difference at all and the United States was just reacting to threats that its trading partners would have made.
3. The WTO coordinated enforcement of trade rules from the states that filed the complaint but didn't enforce anything itself.

- All of those stories fit the result. But more generally, Kono wanted to know if institutions matter. In an extensive review of existing research, he found 3 potential answers:

1. According to John Mearsheimer's article, "The False Promise of International Institutions," institutions don't matter because the international system is anarchic.
2. Anne-Marie Burley and Walter Mattli's article, "Europe Before the Court," says that institutions do matter because they supplant anarchy with some sort of rules of order, which they call "hierarchy."
3. Institutions matter because they remedy market failures that impede cooperation under anarchy, according to Robert Keohane's article, "After Hegemony." Institutions do not fix anarchy entirely but do make the "anarchic system work better."

- Kono restated the 3 stories this way:

1. The story in which the United States felt bound to honor the WTO's decision means that international economic institutions transform anarchy into order—a hierarchical system.
2. The story in which the United States was responding to threats means that the WTO made no difference because the WTO had nothing to do with the threats.
3. The story in which the WTO helped to organize enforcement means that international institutions fail to replace anarchy, but they do treat some of the symptoms of anarchy.

- Kono's work can help us find ways to make international economic institutions work better, at lower cost. If the United States believes that the WTO carries the force of law, then it will abide by its decisions. But if the United States believes that anarchy rules, then it doesn't care what a legal entity thinks. All that matters is America's reputation among its trading partners.

- Kono studies what he calls dispute settlement mechanisms on preferential trade arrangements. He reports that dispute-settlement mechanisms do help, at least on trade liberalization. The entire effect turns on just one thing: the existence of third-party tribunals that have authority among the participants.

- Kono found that more legalistic features, like have a standing tribunal instead of ad hoc panels, or having some international legal authority, don't matter. That's why he concludes that institutions don't formally constrain states. It's the political embarrassment of being found at fault that does the job.

- Kono studied preferential trade arrangements from 1958–1995. Again, he found that the key is third-party review. Additional structure and powers, such as having a standing review board, or having the force of international law, don't have much additional influence.

- Kono interprets this to mean that the public rulings of the tribunal give the winning side a measure of legitimacy, which, in turn, makes it harder for the losing side to retaliate. The reputational penalty would be too large.

- Why wouldn't a standing tribunal make a difference? Kono says that a standing tribunal's advantage is that it should be perceived as less politicized. But Kono's work suggests that it simply doesn't.

- Given his other results and for technical reasons, Kono concludes that it's anarchy out there, and international economic institutions can't change that. Granting additional legal powers probably won't help.

- Instead, Kono argues, international economic institutions should realize that they can make this anarchic system work better. Trying to impose a settlement, for example, presumes a hierarchy of enforcement that doesn't exist. He suggests that the WTO should realize that enforcement is decentralized, instead.

Suggested Reading

Ayres, *Banking on the Poor*.

Barnett and Finnemore, "The Politics, Power, and Pathologies of International Organizations."

Beetham, *Max Weber and the Theory of Modern Politics*.

Call and Barnett, "Looking for a Few Good Cops."

Chopra, "Fighting for Truth at the UN."

Keohane, *After Hegemony*.

Mearsheimer, "The False Promise of International Institutions."

Weiss, "Collective Spinelessness."

Weiss and Pasic, "Reinventing UNHCR."

Questions to Consider

1. Tom Weiss says that international economic institutions get enormous power from their ability to classify objects and define terms, such "refugee." How might that power be abused?
2. What is the best way to evaluate an international economic institution?

LECTURE 4

MESSY MULTILATERALISM

Nations have different interests, and this makes it hard for them to agree on the goals of any international economic institution. Reaching agreement on the rules of such institutions is even harder. The law professors Eric Posner and Alan Sykes say it should be unusual for states to delegate authority to international institutions. You've likely heard the expression, "If you want a job done right, then do it yourself." Economists have a name for that idea: agency costs. The person you hire to do a job doesn't care about it being done right as much as you do yourself. Delegating sovereignty is particularly prone to agency costs. For this reason, states try to avoid extensive delegation most of the time.

Spawning Organizations

- Despite states' trying to avoid extensive delegation, beginning around 1930, nations in the era of big government began forming very large international institutions. Today, we see lots of big international institutions.

- Why is that? The law professor Anu Bradford says that issues such as the environment, free trade, and terrorism can't be handled by individual countries alone. Such complex international issues require continuing international cooperation, she argues, in an article called "How International Institutions Evolve."

- For example, China and India can't be ignored on the environment. They produce too much pollution to dismiss. They're also too powerful to accept any remedy that they don't want.

- An example of the genesis of an international institution is the European Coal and Steel Community. Six nations—France, West Germany, Italy, Belgium, the Netherlands, and Luxembourg—formed this organization after World War II to manage their coal and steel industries.

- The organization disbanded several years ago, but that's not the end of the story: The European Coal and Steel Community evolved into the much larger European Union. Today, the 28-member EU has more than 4 times the membership that the original European Coal and Steel Community had—with influence far beyond coal and steel.

- The story of the European Coal and Steel Community is far from unique. The World Trade Organization (WTO) has its roots in the General Agreement on Tariffs and Trade, known as GATT, which began with 28 members in 1947. Today's WTO has about 164 members. The North Atlantic Treaty Organization, or NATO, began with 12 members in 1949. Today it has 28.

- Membership changes seem to be 1-way, too. New members join while exits are rare. The Sturm und Drang triggered by the United Kingdom's Brexit vote was big news because nothing like that had happened before.

- International institutions—including economic ones—always seem to expand. Does this happen by chance or do underlying forces drive the process?

- A book called *The Size of Nations*—written by Harvard political economist Alberto Alesina and Tufts University economist Enrico Spolaore—argues that the reason we need international institutions is to produce and preserve public goods. And this need typically grows over time.

- Public goods are things like national defense and clean air. To qualify as a public good, there are 2 requirements:

    1. They must be non-rival. One person using a public good—like clean air—doesn't keep someone else from using it.
    2. A public good must be non-excludable. A nation can't keep national defense from protecting a citizen.

- Another public good is free trade. For example, the United States is bad at growing cocoa beans because it's not warm enough, but it is good at growing corn and wheat. It makes sense for the United States to do what it does best and trade with others who are better at other tasks.

- Alesina and Spolaore write that increasing the number of participants in an institution lets states achieve economies of scale. The greater the number of countries that agree to free trade, or to work toward a cleaner environment, the larger the gains.

- The problem is that the larger the membership, the larger the heterogeneity costs—the problems of having different goals. For example, say a small group of states agrees to cut coal consumption. Another member

Today, the 28-member EU has more than 4 times the membership that the original European Coal and Steel Community had.

would make the group more effective. But maybe a country like India or China just can't afford to do that.

- They might be happy to work together on clean water. But coal is off the table, for the time being. As a result, the lost public good—cleaner air—is a heterogeneity cost. Alesina and Spolaore say the tradeoff between size and diversity determines the size of an institution.

- Institutions can grow in 2 ways, and only one of them is membership. Michael J. Gilligan, a professor of politics at New York University, uses the terms *widening* and *deepening* to explain this growth of an institution. Widening means broadening the membership to include new states. Deepening means expanding the areas of cooperation.

> *States try to get the biggest gains they can from cooperation while retaining as much of their sovereignty as possible.*

- Gilligan argues that international institutions shouldn't be able to widen and deepen simultaneously because of the trade-off between the benefits of size and the costs of heterogeneity. That means that international economic institutions ought to be small and deep—or else large and shallow. That's the theory.

- That's not what we see, though. International institutions admit new members even while putting more on their plates. How do they do that? Columbia University's Anu Bradford says that states try to get the biggest gains they can from cooperation while retaining as much of their sovereignty as possible.

- International institutions have ways to manage heterogeneity costs, according to Bradford. She calls the first way consent tailoring. That means the institution overrides the wishes of prospective members. If the prospective member wants

in badly enough, then it will consent to the restriction. Sometimes, the institution wants a state to join badly enough to make concessions of its own.

- Sometimes, the balance of power lies with the nation rather than the institution. Then, the institution must adjust the terms of behavior. Maybe it agrees that the country won't have to hit the fiscal targets for 5 years. The prospective member might accept this deal, and—this time—the international institution can widen its membership through institutional tailoring.

Evolution in Action

- The evolution of an international economic institution often goes like this: A small group of nations agrees that international cooperation on a fairly narrow agenda would be helpful.

- Because the group is small—and the agenda is focused—we can expect the group to be homogenous, with few disagreements. The group can make progress.

- But forces push the institution to grow. Institutionalized cooperation requires a bureaucracy, and bureaucrats are like anyone else: They want more power and influence. That means that bureaucracies tend to grow.

- Additionally, the institution will uncover other areas for productive cooperation that weren't on the original agenda. Say that the countries originally set up the institution to promote free trade in raw materials and would do even better if it expands to allow another country to join.

- But there's a problem: This prospective member is really good at growing sugar, and one of the members—which is also a big sugar producer—doesn't want the competition. On

balance, the existing member decides that it'll be better off despite the competition, because it will enjoy free trade with an extra member in all of the other areas.

- This is an example of consent tailoring. In this case, gains outweigh losses. But further additions might increase heterogeneity and therefore tension.

Heterogeneity in Action

- Why do the members of an international institution care about increasing heterogeneity? A great example is the United Kingdom's Brexit referendum in June 2016, pledging eventual withdrawal from the European Union. There's no doubt that the Schengen Agreement, which opened many internal borders, played a large role in the victory of Brexit advocates.

- More generally, heterogeneity makes it harder to cooperate. Disagreements mean delays. Negotiations are more likely to reach an impasse. That typically either ends cooperation or—to break the deadlock—a brokered agreement requires more compromises, which are usually watered down so that everybody can accept them. At key moments, the least cooperative member of the institution holds the most power.

- Some might think the worst outcome of heterogeneity is that nothing gets done. But it may be worse than that. Consider the World Trade Organization's Doha Round.

- The Doha Round began in November 2001. The WTO's goal was a "major reform of the international trading system through the introduction of lower trade barriers and revised trade rules." Talks broke down in July 2008. Occasional efforts at reviving the Doha Round proved mostly fruitless.

- The delays made some states lose faith in the ability of the WTO to make progress. Consequently, member states have

signed more than 200 smaller bilateral and regional trade agreements. For these states, regionalism replaced the WTO's multilateral trade negotiations. And regional trade agreements further weaken the incentives to complete the Doha Round.

- In some sense, it's hard to imagine how a huge trade deal like the Doha Round could ever succeed. The Vienna Convention on the Law of Treaties—a treaty dealing with international law on agreements between states—has 2 core principles: consent and universality.

- Basically, all parties to a treaty must consent to it. The WTO has upward of 150 members. The bigger an institution gets, the harder it is to achieve universal consent. So the institution either gets nothing done, or else it has to use some sort of majority vote. This forces the losers to participate—and that's not universal.

The Schengen Agreement, which opened many internal borders, played a large role in the victory of Brexit advocates.

- Columbia University's Anu Bradford says that adhering to consent and universality leads to toothless resolutions that are meaningless. And this, she says, "inevitably leads to weak institutions where a large number of states codify the lowest common denominator among them."

Messy Multilateralism

- *Financial Times* correspondent Richard Haass calls today's international relations "messy multilateralism." We still see ambitious agreements like the Paris Climate Accord, but the odds of states actually honoring them are small.

- Think of the Paris Accord's ancestor, the Kyoto Protocol of 1997. The Kyoto Protocol called for a 5% cut in carbon

emissions. The result? A 58% increase. Instead of these grandiose but unworkable agreements, Haass thinks we'll see smaller, more pragmatic deals, perhaps with multiple membership terms and different compliance terms.

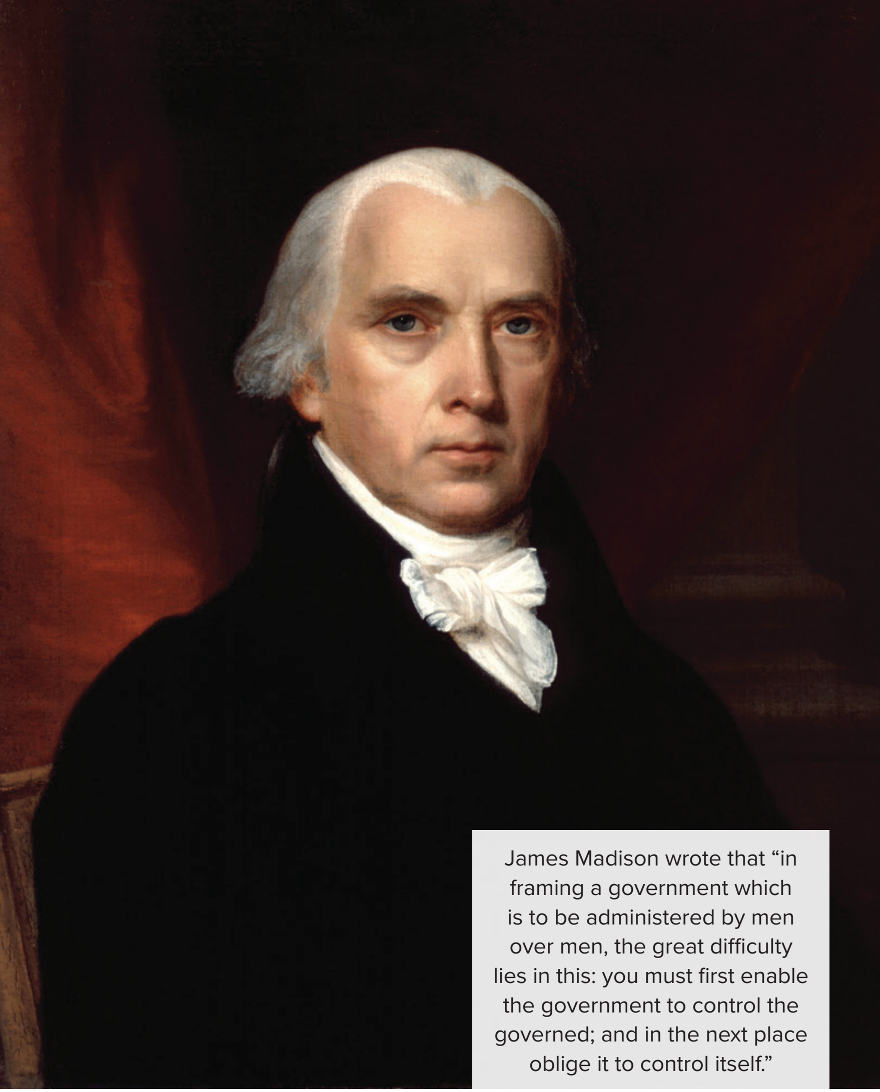
Mission Creep and Mistakes

- Remember that the European Union began with a narrow mandate to integrate Western European steel and coal industries. Today, the EU goes much further. The shape of bananas and cucumbers was regulated. Depending on your point of view, that's either beneficial widening (producing public gains) or bureaucratic mission creep that just butts into other people's business for no good reason.

- Institutions are populated by men and women who are subject to the same desires the rest of us have. They might try to game the system, and they might just make mistakes. For example, they might let a state enter if it initially meets half of the free-trade standards, when if they'd negotiated better, the new member would have agreed to meet 90% of them. That cheapens the price of admission for the next prospective member, too.

- An international institution might also weaken itself if it doesn't enforce the conditions of the group. That encourages other members to renege on their commitments, and makes it harder to enforce those standards when they do renege.

- In retrospect, perhaps the biggest error by an international economic institution was made in the Eurozone. The Eurozone got too big. Economists generally agree that—barring unusual circumstances—you can't have a common currency without a common fiscal policy. And you can't have a common fiscal policy without a common electorate.



James Madison wrote that “in framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.”

- The Eurozone tried to impose an unusual circumstance—international agreements to limit budget deficits—but couldn’t enforce them. The result was a massive transfer of wealth from the taxpayers of fiscally sound states, like Germany, to profligate states, like Greece.

Suggested Reading

Alesina and Spolaore, *The Size of Nations*.

Bradford, "How International Institutions Evolve."

Haass, "The Case for Messy Multilateralism."

Moser and Rose, "Why Do Trade Negotiations Take So Long?"

Questions to Consider

1. Why do nations surrender sovereignty to international economic institutions?
2. What do Alberto Alesina and Enrico Spolaore mean when they say that the tradeoff between size and diversity determines the size of an institution?

LECTURE 5

THE FED AND THE ROLES OF CENTRAL BANKS

As long as there have been banks, there have been problems with banks. Not all problems reach crisis proportions, but some have. The Federal Reserve System, or the Fed for short, was founded to solve—or at least to reduce—the frequency and severity of those problems. The Fed is an enormous institution. It includes the Board of Governors, the Federal Open Market Committee, 12 Federal Reserve banks, more than 20 branches, and several advisory committees. In short, the Fed is the central bank of the United States. And being the central bank of a large country like the United States is a large job.

Overview of the Fed

- The Fed is charged with providing stable economic growth, low inflation, and healthy employment. Like most institutions, the Fed has had mixed success.

- The Fed today is the nation's 3rd try at establishing a central bank. The first 2 attempts didn't last. The United States was once a new nation of 13 states with a strong independent streak: People weren't fond of central authority.

The Fed is charged with providing stable economic growth, low inflation, and healthy employment. Like most institutions, the Fed has had mixed success.

- The 3rd try came about after a couple of serious banking panics in 1893 and 1907 that got the attention of the voters and politicians alike. In 1908, Congress passed the Aldrich-Vreeland Act, which created the National Monetary Commission.

- Its job was to find a way to eliminate future financial panics and to keep the banking system stable. Senator Nelson W. Aldrich of Rhode Island was the chairman. The Aldrich plan, issued 3 years later, recommended the creation of a central banking system.

- After lots of political dancing, the result was the Federal Reserve Act in December 1913. The act created a hybrid institution: a public-private, regional-centralized organization. The main players in this organization were (and remain) the Board of Governors in Washington DC and 12 regional banks.

- It's a gross oversimplification to single out 1 thing as the Fed's main job, but it's the lender of last resort, if you narrow the Fed's chief responsibility down to damage control. The idea is that the Fed would lend freely, at a penalty interest rate, and against good collateral, from sound banks with temporary liquidity problems.

- Banks are allowed to fail. It's the Fed's job to prevent the banking *system* from failing. That's a big difference. The economy can withstand a bank failure here and there. It's only a systemic problem if lots of people panic—and lots of banks fail—within a short period.

Central Banking History

- The United States was a laggard on the world stage, in terms of central banking. By the time the Federal Reserve Act passed, most of the bigger European economies already had some form of central bank, usually based upon the model of the Bank of England. The American population, though, had been suspicious of a national bank since the American Revolution. It feared concentrations of power because that leads to corruption.

- After the Revolutionary War, Alexander Hamilton became the point person for supporters of a central bank. Hamilton argued the new nation needed a national bank to lubricate the flow of credit. Others, like Thomas Jefferson, argued that the Constitution didn't specifically give the federal government the power to create a central bank.

- Despite the efforts of Jefferson and his supporters, Hamilton prevailed. In 1791, President George Washington signed a bill granting a 20-year charter to the First Bank of the United States, located in Philadelphia.

- But by 1811, when the bank's charter was up for renewal, Congress decided to let it lapse. This was partly because about two-thirds of the bank's stock was held by British individuals and institutions and partly because domestic inflation had been bad. Prices rose more than 70% during the first few years of the bank's existence.

- The War of 1812 revived interest in a central bank. Wars are expensive, and there are only 3 ways to get funds for them, or for any government project:

  1. Taxes. Taxes can take time, which makes them ill suited for war, and they are also painful to the populace.
  2. Government borrowings. These are less obvious than taxes, but borrowing money is still very visible, and the debt must eventually be repaid.
  3. Printing money, which has the advantage of being fast. That's a real advantage during wartime. Printing money also hides, for a time, the cost of the war.

- In 1816, shortly after the war of 1812 ended, President James Madison authorized the Second Bank of the United States, with functioned very much like the first. Once again, its first few years were troubled. Some historians believe that mismanagement helped cause the panic of 1819.

- Andrew Jackson became president in 1829, and he was wary of centralized power. At the time, the Second Bank was handling about 20% of the nation's loans. Jackson didn't like that, but he didn't have the political clout to kill the Second Bank outright. Instead, he began a political campaign.

- In September 1833, the government announced that it would withdraw the national funds from the Second Bank and put them in state-chartered banks. Political infighting continued, with favors traded and backs scratched, until 1836, when the bank's charter came up for renewal. Jackson won. Congress let the bank die.

- The federal government produced very little banking regulation for the next 75 years. Banking charters were authorized by states. The state banking system was hardly perfect: State charters led to influence peddling.

- To counter corruption, about 15 states enacted legislation known as free-banking bills from 1837 to 1862. The idea was that banks are fundamentally like any other business, so if you met certain basic business criteria, then you could open a bank.

In 1816, shortly after the war of 1812 ended, President James Madison authorized the Second Bank of the United States.

- These institutions could even issue bank notes that functioned as currency, with no restrictions beyond compliance with general business law. Instead of using dollar bills, for instance, you'd use currency issued by a bank.

- On the plus side, a bank couldn't survive if people didn't trust its currency, so banks had powerful incentives to keep their reputations spotless. A bank had no room for error. On the minus side, some people didn't trust the notes of even safe and sound banks. That made transactions more difficult because a quoted price might be good only in notes from certain banks.

The National Banking Act

- Free banking in the United States ended in 1863 when Congress passed the National Banking Act. This law established nationally chartered banks, which would issue bank notes—currency—backed by US Treasury securities. The act also established the Office of the Comptroller of the Currency, or the OCC, which supervised federally chartered banks.

- The biggest plus to the National Banking Act was probably the establishment of a uniform currency. By law, all national banks had to accept each other's currency at full value. That made transactions easier.

- The year the National Banking Act became law—1863—is not entirely an accident. At the time, the northern Union was engaged in a bloody war with the breakaway Confederate States and needed money to finance the campaign. The National Banking Act required national banks to back their notes with US Treasury securities. That expanded the market for government securities, making it easier for the north to borrow to continue the war.

The Federal Reserve Act

- The National Banking era lasted for 50 years, ending with the Federal Reserve Act of 1913. Coming on the heels of the banking panics in 1893 and 1907, the idea of a central bank had by then gained new traction.

- Central planning was also gaining favor within the United States and internationally. Some people thought that not having a central bank proved that the United States was an economic backwater.

- Most Americans rejected extremes in central planning, but even people who rejected the idea of central planning tended to agree that having a central bank made international monetary cooperation easier.

The biggest plus to the National Banking Act was probably the establishment of a uniform currency.

- The Fed had problems of its own, and it caused a few, too. There's no question that the Federal Reserve has made a lot

of mistakes. But you can also make the case that whatever the Fed's problems were in its infancy, it has done better over the years.

- Even so, there's no denying that the Fed's performance during its first few years was weak. From 1913 through 1920, prices in the United States more than doubled. Inflation was on the order of 5 times higher than it had been during the previous 35 years. When the Fed finally raised rates to slow inflation, it mis-guessed the size of the increase and helped trigger a recession.

- A few years later came the Great Depression. There were many causes of the Great Depression, but just about all monetary scholars and historians agree that among the biggest was the Fed's failure to offset a dramatic drop in money corresponding to the rise in bank failures. Congress reorganized the Fed in 1935 in the hope that future results would be better.

- More recently, the Fed was responsible for the Great Inflation of the 1970s. That was when prices rose at double-digit rates because monetary policy was too loose under Fed chairmen Arthur Burns and G. William Miller, according to the central bank scholar Allan H. Meltzer.

Successes

- From 1970–1982, the United States experienced *stagflation*, the unhappy combination of a stagnant economy and high inflation. The solution was a strong leader to change monetary policy. President Jimmy Carter nominated Paul Volcker as chairman of the Board of Governors of the Federal Reserve System in 1979.

- Volcker rightly saw that inflation depends on monetary growth. If too much money chases too few goods, then you get higher

prices. Tamping down money growth drove up interest rates, though, and the United States had a severe recession.

- It took a strong leader to stay the course in the face of recession and political pressure. The United States emerged from that period with stable prices and strong economic growth for 2 decades.

- From about 1986 to about 2002, Federal Reserve Chairman Alan Greenspan produced the best sustained results during the Fed's history. Meltzer attributes this to the Fed following a monetary rule of the type developed by Stanford economist John Taylor. The idea is to forget trying to fine-tune the economy and just provide moderate, steady, and predictable growth in money supply. The result, says Meltzer, was low inflation, brief recessions, and quick recoveries.

- The Fed also generally gets good marks for quick—and at least somewhat decisive—action in 2008 to mitigate the financial crisis. However, the long period of quantitative easing that followed—that is, bringing new liquidity into the money supply—gets mixed reviews; it's unlikely the debate will ever be settled.

Mission Creep

- Over the years, the Federal Reserve System's mission has evolved. Some of that is normal: Circumstances change and institutions must adapt. But the Fed has also experienced a gradual extension of its original mandate that people call mission creep.

- Historically, the Fed was responsible for conducting monetary policy and serving as lender of last resort. But over time, the Fed's mandate and supervisory responsibilities grew.

- In 1977, Congress amended the Federal Reserve Act to expand the Fed's mandate to include maximum employment, along with stable prices. Depending on which economic school of thought you favor, the twin goals of maximum employment and price stability can be in opposition. The dual mandate makes it too easy to scapegoat the Fed.

In 1977, Congress amended the Federal Reserve Act to expand the Fed's mandate to include maximum employment, along with stable prices.

- In 1980, the Depository Institutions Deregulation and Monetary Control Act re-regulated several aspects of the American financial system and gave the Fed more responsibilities for banks that weren't members of the Fed system.

- The huge Wall Street Reform and Consumer Protection Act of 2010—better known as Dodd-Frank—shook up the Fed's role still more. It set up the Financial Stability Oversight Council to monitor risk in the financial system, with the Fed as a member.

- The Fed gained supervisory responsibility over savings and loan holding companies, too. The idea of Dodd-Frank, like so many pieces of legislation before it, was to make sure that we never experience another financial crisis. We'll see if it pulls that off, but there are doubts to be had.

Suggested Reading

Apel, *Central Banking Systems Compared*.

Bordo, "A Brief History of Central Banks."

Federal Reserve Bank of Minneapolis, "Central Bank History."

Goodman, *Monetary Sovereignty*.

Schwartz, "Banking School, Currency School, Free Banking School."

Selgin, *The Theory of Free Banking*.

Todd, *The Balance of Power*.

White, *Free Banking in Britain*.

Questions to Consider

1. Why do nations have central banks?
2. How can governments raise funds? What are the advantages and disadvantages of each? Give an example of how a government might do well to change the way it raises funds, depending on circumstances.

LECTURE 6

THE PRE–WORLD WAR II RISE OF BIG GOVERNMENT

The world has seen many different forms of government, and some are more conducive to international cooperation than others. This lecture can't cover them all, but the rise of international economic institutions—and the growth of big government—seem to be linked. This lecture takes a look at a few major systems of government while describing their relationships with institutions.

Extreme 1

- This lecture will begin by comparing 2 extreme political types: totalitarianism and pure democracy. Totalitarianism is the political system that probably is the least entwined with economics. *Merriam-Webster* defines totalitarianism as "centralized control by an autocratic authority" or "the political concept that the citizen should be totally subject to an absolute state authority."

- That absolute state authority is a single political party. Think of the Soviet Union under Stalin or Germany under Hitler.

- Notice 2 key features: First, totalitarian states require centralized control, almost always described as autocratic. Second, they feature the subordination of the individual to the state.

- Benito Mussolini, the leader of Italy's National Fascist Party, was probably the first to use the term "totalitarian," in the early 1920s. Totalitarianism has blighted the world throughout history, though. Totalitarianism subordinates all aspects of the individual.

- In most cases, a single charismatic leader's wishes are the ultimate authority. Organized violence, even on a massive scale, is perfectly fine if it advances the ruler's agenda.

- That might sound like a dictatorship, and indeed, totalitarian regimes are much like dictatorships. A key distinction is that totalitarians uproot legal and social traditions and replace them with other norms that fit the state's agenda.

- For example, the state might attack the traditional family unit. If more children are born into single-parent households, then it's easier for the state to inject itself into child rearing, which makes indoctrination much easier. That, in turn, strengthens the state.

- One can see how an international institution—economic or otherwise—would appeal to totalitarians. They are used to running the show in their own countries, and tend to try to uproot traditions, so why not try to influence other countries, too?

Benito Mussolini, the leader of Italy's National Fascist Party, was probably the first to use the term "totalitarian," in the early 1920s.

- Imagine working for an international economic institution. Working with representatives of a totalitarian government

presents different dynamics than the ones you might expect if you live in a democracy. Agreements with totalitarians depend on who happens to be in charge much more than they do with democratic officials. Long-term planning is more difficult.

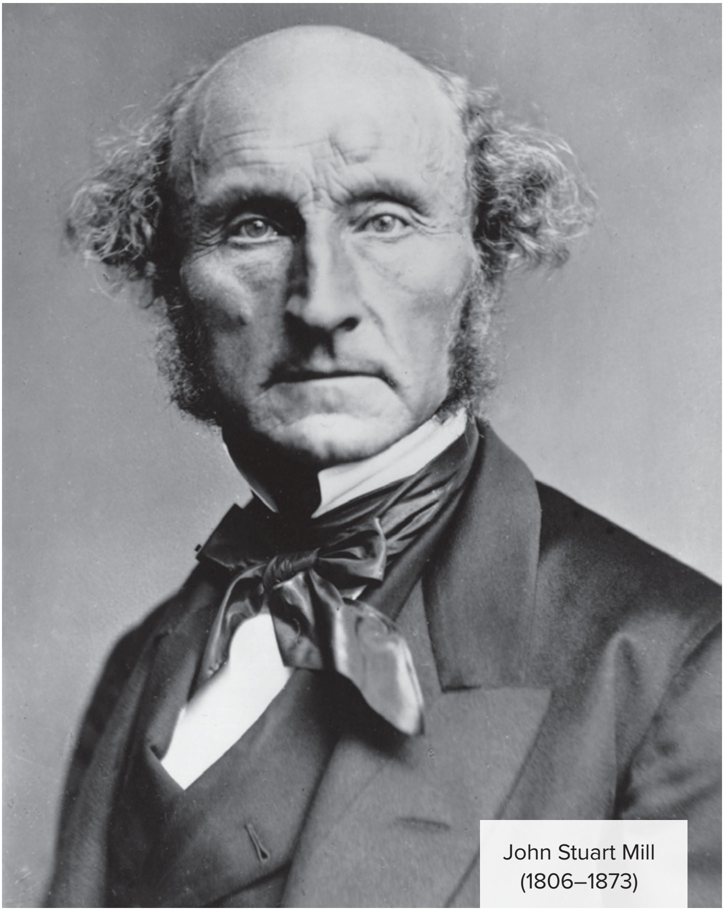
Extreme 2

- At the other extreme from totalitarianism is pure democracy. Note the modifier, *pure*. That's necessary because, as is true for other political and economic systems, there are many different forms of democracy. Voting and the idea that rulers hold power through the consent of the governed are central to democracy.

- The United States isn't a pure democracy. The Founders knew that it's just not possible for every citizen to vote on all or even most issues. Instead, they formed a republic. In a republic, citizens who are entitled to vote hold power, and they choose people to represent them. These representatives actually make the decisions. This system works better because citizens just don't have the time to vote on every government activity.

- Most citizens of advanced nations prefer democracies to other forms of government. That might be because nations with other forms of government are unable to *become* advanced. Still, democracies do have fundamental problems and vulnerabilities.

- John Stuart Mill, in his famous book *On Liberty*, popularized the concept of the tyranny of the majority. Suppose that 90% of the voters decide that the other 10% should be barred from holding government office, or even enslaved, just because of their religion. Most of us wouldn't approve. Ten percent of the population might as well be living under a totalitarian system.


John Stuart Mill
(1806–1873)

- Democracies can limit this problem with a constitution. Most constitutions list government powers, and they also limit these powers so that the fundamental rights of citizens are protected. In the United States, the Bill of Rights outlines those fundamental rights.

- The separation of powers can also help protect against the tyranny of the majority; for example, take the United States' executive branch, legislative branch, and judicial

branch, which work to keep each other in check. Without an effective system of checks and balances, a nation can drift toward totalitarianism or dictatorship.

- Another potential—and some say inevitable—problem is fiscal irresponsibility. Several Latin American countries—and European nations such as Greece—have seen democracies collapse when their economies failed under excessive public debt and unsustainable spending. That hasn't happened in the United States yet, but it is worth checking the trajectory of the nation's debt.

- Federal Reserve data tell a scary story. As late as 1980, the federal debt was about 30% of gross national product, or GDP. By the mid-1990s, it was up to about 65% of GDP, and stayed in that general area until about 2010.

- Since then, the level of national debt has surpassed 100% of GDP. That means that the entire output of the entire nation, for an entire year, would still not quite be enough to repay the existing debt burden.

- Although leaders of democratic nations don't have the absolute power of a dictator or totalitarian, they still might want international economic institutions. Many democracies produce very big governments, and they might want to influence other countries, too. They might also form some supra-national institutions to make international trade easier.

Fascism

- How does one define the term *fascism*? It can be tricky: In *Politics and the English Language*, George Orwell wrote, "The word *Fascism* has now no meaning except in so far as it signifies 'something not desirable.'" Regardless, we can identify some required traits of a fascist government.

- *Merriam-Webster* defines fascism as a "philosophy of government that stresses the primacy and glory of the state, unquestioning obedience to its leader, subordination of the individual will to the state's authority, and harsh suppression of dissent. Martial virtues are celebrated, while liberal and democratic values are disparaged."

- Fascism arose during the 1920s and 1930s partly out of fear of the rising power of the working classes. Fascism helped to preserve class distinctions between cultural, business, and economic elites and the working class.

- This is in stark contrast to the political aspect of communism, which claims to strive for a classless society. And this helps to explain the animosity between the Soviet Union and Germany—and also fascist Italy and Spain—during World War II.

- "Unquestioning obedience" to a leader means that fascist states are totalitarian or dictatorships. Classic examples from the 1920s through World War II are the axis powers: Italy under Benito Mussolini from 1922 through 1943; Germany under Adolf Hitler from 1933 through 1945; and Japan under Hirohito from 1926 through 1945.

> *Fascism arose during the 1920s and 1930s partly out of fear of the rising power of the working classes.*

- Spain, which under fascist Francisco Franco, stayed neutral during the war. Fascism lasted longer in Spain, from 1939 through 1975. Modern examples of fascist leaders are Cuba's Raúl Castro and his late brother, Fidel.

- Jonah Goldberg's controversial best-seller *Liberal Fascism* says that before the Holocaust, fascism was often viewed as favorable and progressive. "Before the war," Goldberg

writes, “fascism was widely viewed as a progressive social movement with many liberal and left-wing adherents in Europe and the United States; the horror of the Holocaust completely changed our view of fascism.”

- After the Holocaust, this view was impossible to sustain. “After the war,” says Goldberg, “the American progressives who had praised Mussolini and even looked sympathetically at Hitler in the 1920s and 1930s had to distance themselves from the horrors of Nazism.”

- To recap: Fascism is a political system featuring a centralized autocratic government that celebrates the state and suppresses the individual. Fascism believes in racial superiority and tolerates no opposition. Genocide is an option.

- If you live in a world with fascist regimes, you’ll be keenly aware that cooperation with your non-fascist neighbors is a good idea. Defense alliances make even more sense than they usually do. Cooperation in defense often leads to economic cooperation, too.

Oligarchies

- In an oligarchy, an elite class rules. Usually, this class is based on wealth, family ties, or royalty. Robert Michels—a German sociologist who lived from 1876 until 1936—believed that any political system eventually evolves into an oligarchy. In his book *Political Parties*, Michels called this the “iron law of oligarchy.”

- The idea behind the iron law is that any successful organization needs competent leaders, and *somebody* has to be the boss. The boss—let’s call the boss the president—can’t do everything. So the system needs a way to choose people for supporting roles.

- In the United States, voters elect the members of Congress, and the president appoints people to fill other specialized roles, like secretary of state and the chair of the Board of Governors of the Federal Reserve System.

- Michels believed that people, particularly in large groups, seek reassurance and guidance from their leaders. However, he also suggested that the professional and class differences between the rank-and-file and the leaders could add to the ability of those leaders to make self-serving decisions instead of meeting the group members' needs.

- When the president leaves office, who are the logical replacement candidates? A vice president; a secretary of state; a senator who has built a network among other politicians; or, as we saw in 2016, a business executive with deep pockets and name recognition.

- The spouse, brother, or daughter of a well-known political figure also has name recognition, and the ability to open doors that are locked to others. We've seen this in the United States with the Kennedys, Bushes, and Clintons.

- Michels, and others like him, believe that democracies are oligarchies. Over time, they contend, politicians and bureaucrats become insulated from those they rule. Ruling elites in democratic societies have more in common with each other than they do with their respective constituencies. The rest of the voting populace lives outside this bubble, and, in many instances, they don't see much difference between political rivals.

- International institutions succumb to the same type of pressures. Decision makers are often longtime employees of the institution and are chosen partly because their views are similar to the previous decision maker's. New leaders must contend with the existing bureaucracy, which has lots of inertia and tends to be resistant to change.

Big Government

- Americans consistently *say* that they worry about the size of the federal government. One example is a Gallup finding headlined, "Record High in U.S. Say Big Government Greatest Threat." This was at least the 48th consecutive year that survey respondents ranked big government as a bigger threat than either big business or big labor.

- When are people more likely to support Big Government? The Austrian economist Friedrich Hayek thought that people would support larger government in times of national crisis, especially wars.

> *Ruling elites in democratic societies have more in common with each other than they do with their respective constituencies.*

- One example is the 9/11 bombings, which occurred in September 2001. That disaster led to talk of a war on terror. Hayek wouldn't have been surprised that since 1970, the only big drop in the percentage of those naming government as the biggest threat came in 2002, right after the 9/11 bombings of the World Trade Center and the Pentagon.

- Along with their stated concern for the threat of big government, people say that corruption is widespread throughout the US government. A 2014 Gallup survey found that fully 75% of US adult respondents answered "Yes" to concerns about government corruption.

- Joseph Tainter writes in his book *The Collapse of Complex Societies* that although US society is not likely to collapse as a whole, some institutions within the United States society might be near the failing point. Tainter thinks that over time, societies accumulate larger and more complex

bureaucracies, with larger and more layers of institutions, rules, and regulations.

- These institutions might offer short-term advantages that outweigh their initial costs. But they also create an increasingly inflexible society. At some point, a new crisis—which the institution could have handled easily during its more dynamic years—leads instead to institutional and societal collapse.

Suggested Reading

Allardyce, "What Fascism is Not."

Bradley Jr., "Enron."

Diamond, Jay, Plattner, *Electoral Systems and Democracy*.

Ebenstein, Ebenstein, and Fogelman, *Today's ISMS*.

Friedman, *Capitalism and Freedom*.

Friedman and Friedman, *Free to Choose*.

Goldberg, *Liberal Fascism*.

Hayek, *The Road to Serfdom*.

Mitchell, *The Pathology of Privilege*.

Reynolds, "When Life Gives You Lemons, Apply For a Business License?"

Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*.

Soule, *The Coming American Revolution*.

Tainter, *The Collapse of Complex Societies*.

Questions to Consider

1. Is there a connection between the rise of big government and the formation of international economic institutions? Why or why not?
2. Robert Michels coined the phrase “iron law of oligarchy.” What does that mean? Do you believe that it’s true? If so, then do you believe that it’s good, bad, or neutral?

LECTURE 7

INTEREST GROUPS, THE STATE, AND CORPORATISM

International institutions came to prominence in the late 19th century and took off after World War I and World War II. Why then? The Austrian economist Friedrich Hayek suggested that big wars can foster reliance on big government. A command approach has become the status quo. Once the idea of the command economy takes root, many nations find the next step—of forming international economic institutions—to be a relatively easy progression. Around the world, nations have adopted big government and command economies to different degrees, and societies have organized themselves in different ways.

Economic Freedom

- In Washington, the Heritage Foundation—a conservative policy institute—produces an annual index of economic freedom in which a completely oppressive nation like North Korea rates close to 0 and the freest nations—like Singapore, New Zealand, Switzerland, and Australia—rate near 100. The Heritage Foundation considers traits such as property rights, business freedom, government spending, and labor freedom to build a rating for each country.

- Hong Kong perennially appears near the top of the 175 or so nations that are evaluated, with a score in the high 80s. North Korea stands alone at the bottom, usually scoring in the low-single digits.

- Over time, the United States has fallen in the rankings. But it remains in the upper second tier, a "mostly free" nation in the Heritage Foundation's estimate, alongside Canada, Chile, Ireland, Estonia, the United Kingdom, and others.

- The link between economic freedom and prosperity is strong. An increase of just 1 point in the economic freedom index is associated with a $1900 increase in per capita income, according to economists Jody Lipford and Bruce Yandle.

- The Federal Reserve Bank of Atlanta uses the Heritage Foundation's freedom ratings to produce an assessment that ranges from a pure command economy (with production and consumption decisions imposed from above) to a pure market economy. In between is a mixed economy, which has traits of both.

Command versus Freedom

- In principal, control economies and free economies each have pluses and minuses. But the scales do not balance.

- Control economies are good at moving resources. If the nation needs tanks, then when the ruler says to produce tanks, the people have to do it, or at least try. But control economies often move resources to the wrong places, propping up inefficient companies instead of letting better companies win in the marketplace. Russia's state-controlled energy conglomerate, Gazprom, is a perfect example.

- Governments have a bad track record of picking successful industries and companies. Price controls always cause

shortages and long lines for what goods are available. Even if a central planner is wise and honest, the planner never has enough information to make the right decision in time.

- Another problem with control economies is that innovation slows. In a culture that relies on instructions from above, it's risky and unprofitable to try alternative ways to solve a problem.

- Free economies produce much higher standards of living because companies there must compete to sell their products to consumers, who make their own choices. If your product is too expensive for a given level of quality, then you're going out of business eventually. That forces companies to innovate to find ways to produce things at lower costs.

Free-Market Criticisms

- The downside to a free market is that public goods like national defense don't get produced in sufficient quantity.

- Public goods are non-rival, meaning that when a person consumes them, it doesn't keep another person from consuming them. Public goods are also non-excludable, meaning that we can't keep each other from consuming them. If a person is protected by national defense, they can't keep another person from being protected.

- That sets up what economists call a free-rider problem. People might have the incentive to opt out of paying for national defense: A single person not paying won't affect national defense all that much.

- The problem, though, is that 1 person's reason for not paying works for everyone else, too. The free-rider problem means that public goods tend to be under produced. Public goods might be necessary but they are rarely profitable to private

investors. That means that some centralized authority usually has to produce them, often through taxation of large numbers of people.

- Free-market economies are sometimes criticized for concentrating wealth among a relatively small percentage of the population. But that is also true in control economies: A relatively small percentage of the population lives extremely well, while the masses live in poverty.

The downside to a free market is that public goods like national defense don't get produced in sufficient quantity.

- That might be for political reasons rather than economic ones. The people who comprise the central authority don't have to feather their own nests. But the fact is that they almost always do.

Capitalism

- Capitalism requires private ownership, particularly of the production process. Capitalism also requires a profit motive because in a capitalist system people recognize that they will benefit more from what they produce if they work harder.

- Ludwig von Mises, an Austrian free-market economist, liked to think of capitalism as a market system with little or no government intervention.

- Capitalism is the most common economic system in the Western world. As feudalism began to recede in the 15th century, capitalism gradually replaced it in Europe. From there, it spread to some of the European colonies. Most scholars credit capitalism with fostering the industrial revolution, which lifted the standard of living of those involved.

- To simplify, capitalism has 2 classes of products: capital goods and consumer goods. Capital goods are 1 of 2 inputs needed to produce consumer goods. Examples of capital goods are metals, machines, and trucks. Examples of consumer goods include food, phones, and clothes.

- Capital goods can't produce consumer goods by themselves, of course. The other input is labor. Labor is more than running machines and repairing roofs. Management provides labor, too, and so do entrepreneurs.

- In a capitalist economic system, the private sector, not government, owns the capital goods. These owners are called capitalists.

- The most extreme form of capitalism is usually called free-market capitalism or *laissez-faire*, the French term for "let it be." Under laissez-faire capitalism, the state's job is to protect property rights, to provide law and order, and to enforce contracts. No nations operate under such a system. Singapore and Hong Kong probably come the closest.

- In contrast, mercantilism—which predated capitalism in much of Europe, from the 16th to 18th century—ties the state's interests to business interests. This too often leads to protectionism. Politicians like to boast about protecting jobs, but if they do that by barring efficient foreign companies from competing, then consumers lose.

> *In a capitalist economic system, the private sector, not government, owns the capital goods. These owners are called capitalists.*

- If the economic system is driven by both the private sector and the government, then you have a mixed economy. Most people agree that the United States is a mixed economy.

Communism

- Under communism, the government owns the means of production, and there is no private property. But that leaves unspecified who owns the non-productive assets.

- A communist state isn't necessarily totalitarian: In the final stage of communism, the state has withered to nothing and goods are distributed according to one's needs, according to Karl Marx. Marx would probably agree that the final stage of communism requires a wealthy society.

- There are several flavors of communism, just as with capitalism. Here are 3: Leninism, Maoism, and Stalinism.

- Leninism said that a society needs a dedicated, professional group of revolutionaries to violently overthrow the capitalist system. A dictatorship of the proletariat then guides society until the happy day when the state withers. Under Leninism, control of all aspects of life by the Soviet communist party led to one of the first modern totalitarian states.

- Mao Zedong—the founder of the Chinese communist revolution—couldn't make Leninism work in China. There just weren't enough members of the proletariat in China's

Mao Zedong (1893–1976)

predominantly rural agrarian society to make a proletariat revolution feasible. Instead, Mao's form of communism—Maoism, of course—substitutes the peasantry for the proletariat. Until then, traditional Marxists had paid little attention to peasants.

- Mao's reign was bloody by any standard. The website necrometrics.com puts the Mao death toll at around 40,000,000 people.

- Joseph Stalin took a different approach. His goal was to achieve socialism in 1 country first. He wasn't picky about who championed the revolution, and he racked up a high death toll.

Stalin was willing to put the struggle for a world revolution on the back burner, instead focusing on a single country. His death toll was still high.

Socialist Economies

- In a pure communist economy, property is held in common. But how much social control does a socialist economy have? That depends.

- The root of socialism is social control. Typically, this means the government owns the principal means of production.

- In principle, socialism can feature a powerful individual or group. The Soviet Union is the poster child for that. The Soviet

Union was in the socialist stage of its failed attempt to achieve true communism and the central government was in total control.

- At the other end of the spectrum, countries like Denmark and Sweden are socialist with no communist aspirations. These countries were—and still are—much freer than the Soviet Union ever was. There's a limit though, because the state must be strong enough to enforce the control of society. Socialist economies are less free than capitalist economies.

- But socialism is closer to capitalism than it is to communism in at least one important way: Nothing in socialism prevents greatly unequal wealth and income. Material equality isn't necessary for an economy to be socialist.

Corporatism

- Corporatism stands in the muddled middle between economic systems and political systems. *Merriam-Webster* defies corporatism as "the organization of a society into industrial and professional corporations serving as organs of political representation and exercising control over persons and activities within their jurisdiction."

- Under corporatism, corporations serve as an organ of political activity—as do unions, the American Medical Association, and so forth. After World War II, the governments of many democratic western European countries—think Austria, Norway, and Sweden—developed strong corporatist elements. The goal was to create mechanisms to prevent destructive battles between businesses and trade unions and to promote cooperation between government and business.

- Because such a system is built on cooperation, and the ability to get things done, this can work well in the right

hands. But a system that *must* be in the right hands can be very dangerous.

- Here's an example: The US government and labor unions carved out an exemption from the Affordable Care Act that was instrumental in getting the union's backing for the legislation, ensuring its passage. People who like the outcome probably believe that power was in the right hands. People who don't like the outcome probably believe that power was in the wrong hands.

- In corporatist societies, economic, political, and social power is in the hands of business and government elites. The state is both powerful and interventionist.

In corporatist societies, economic, political, and social power is in the hands of business and government elites. The state is both powerful and interventionist.

- The Enron Corporation can serve as a case study. Enron was formed in 1985 as a result of the merger of Houston Natural Gas and InterNorth. For awhile, it racked up big profits while behaving like a socially conscious, green company. What's not to like, right?

- However, a former longtime Enron employee named Robert Bradley Jr. has written that there were plenty of things not to like. Enron was very good at cooperating with the government to extract subsidies for itself in exchange for advancing certain government objectives.

- Free-market capitalism isn't supposed to work that way, but in a mixed economy it often does. Under capitalism, you're supposed to out-compete your competitors by producing a better product at a lower price. You're not supposed to get the government to lean on the competition.

- Under corporatism, though, government and business cooperation is fine. In Enron's case, the government got important support from a big corporation, and Enron got awards while its competitors got hamstrung, all in the name of advancing their shared green agenda. The former Enron employee-turned-author Bradley concludes that Enron was "essentially a political company, not a free-market one."

Suggested Reading

Barak, *The Judge in a Democracy*.

Bradley Jr., "Enron."

De Soto, Hernando. *The Mystery of Capital*.

Friedman, *Capitalism and Freedom*.

Hayek, *The Road to Serfdom*.

Lipford and Yandle, "Determining Economic Freedom."

Mitchell, *The Pathology of Privilege*.

Questions to Consider

1. Why is it so hard to disentangle economic systems from political systems?
2. Do you believe that the link between economic freedom and prosperity is just chance, or are there good reasons to suspect that one causes the other?

LECTURE 8

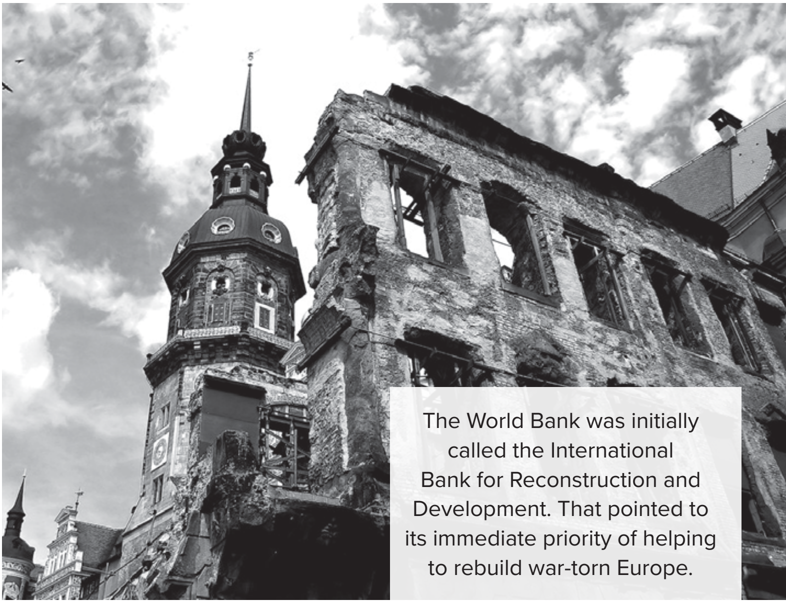
THE WORLD BANK, POVERTY, AND VIOLENCE

The link between poverty and violence makes intuitive sense. Poverty can breed a sense of unfairness and envy in addition to causing ongoing suffering. Scott Gilmore, a former Canadian diplomat and international affairs columnist, says, “Without development, instability and war become far more likely.” And one can make the case that increasing development around the world is a wonderful goal, in and of itself. It’s a form of national defense—a way to prevent violence.

The IMF and World Bank

- In the book *The Battle of Bretton Woods*, author Benn Steil says that during the Bretton Woods conference in 1944—which produced the World Bank, the International Monetary Fund (IMF), and the post-war gold standard—the incipient World Bank was clearly given second-class status.

- Keeping the World Bank and the IMF separate—in our minds and in their functions—is harder today than it used to be. Both institutions have experienced mission creep and



The World Bank was initially called the International Bank for Reconstruction and Development. That pointed to its immediate priority of helping to rebuild war-torn Europe.

therefore have moved toward each other in their missions. Still, we can identify some key differences.

- First, the IMF remains responsible for its original mission of exchange-rate stability. The World Bank doesn't do anything like that.
- The IMF makes much larger loans—sometimes many billions of dollars' worth, targeting entire nations for assistance. In contrast, the World Bank makes much smaller loans, perhaps in the tens of millions of dollars, up to a few hundred million. The World Bank picks specific targets, like building dams and pipelines.

Jim Yong Kim

- In early 2012, Dartmouth College president Jim Yong Kim was tapped by the White House to lead the World Bank for

the next several years. Along with a Ph.D. in Anthropology, he had many impressive achievements, but no expertise in banking or related fields.

- Having an atypical background is neither good nor bad in itself. Dr. Kim's training was at least related to the World Bank's mission, and he had been, as he put it, "Doing development on the ground for the last 25 years."

- Dr. Kim isn't trained as an economist, but knows to ask questions like one. Also like an economist, he understands that people respond to incentives. Raise the wage level, for example, and—all else being equal—more people want to work more hours. But employers can't afford to hire all of people who want to work. The result is unemployment.

- Dr. Kim had also been active in the "50 Years Is Enough" movement, which was highly critical of international economic institutions like the IMF and the World Bank. The 50 Years Is Enough movement advocated closing the multilateral institutions, believing that they did more harm than good.

- But the movement was not successful. Dr. Kim, by virtue of his appointment to the helm of the World Bank, set the institution on a different course instead.

- The bank's mission remains putting an end to extreme poverty around the world and its focus is still on the poorest 40% of the people in any developing country. The difference is that prior to Dr. Kim's leadership, the World Bank focused on increasing a nation's gross domestic product, or GDP.

- Former Treasury Secretary Lawrence H. Summers published a paper in 2013 showing that better health contributed about a quarter of the economic growth in low- and middle-income

countries from 2000 to 2011. That sparked something of a revelation at the World Bank.

- If the goal is to reduce poverty, then why should the World Bank limit itself to bridges, dams, and the like? Improving health and education is an investment in human capital, instead of physical capital. But both can reduce poverty. Dr. Kim isn't afraid to try out some new strategies, like education and health initiatives, to reduce poverty.

- For example, in a report on development, the World Bank described a long-standing intervention among poor families in Jamaica. Some of the children were stunted, meaning they were abnormally small for their age. Past a certain point, brain development begins to suffer.

- An intervention program involved workers visiting mothers and stressing how important it is for them to interact with their children. Families received 2 years of intervention. After 22 years, the stunted children whose mothers had received this intervention had incomes that were equal to the non-stunted children. The ones that didn't had incomes were 25 to 30% lower.

The World Bank's mission remains putting an end to extreme poverty around the world, and its focus is still on the poorest 40% of the people in any developing country.

- Dr. Kim would be the first to admit that the World Bank has had its share of failures. After all, he did take steps to change its focus and programs.

- Evicted and Abandoned (E&A) is an international organization that has criticized the World Bank, charging it with "regularly [failing] to follow its own rules for protecting vulnerable populations." Here are just three of E&A's examples.

- According to E&A, the World Bank has funded projects that have physically or economically displaced an estimated 3.4 million people in the last 10 years.
- In another case, Ethiopian authorities diverted millions of dollars from a World Bank project. Ethiopian leaders used that World Bank money to fund mass evictions, often resorting to violence.
- Another example is the effect of World Bank projects on the environment. "From 2009 to 2013," E&A says, "World Bank lenders pumped $50 billion into projects graded the highest risk for 'irreversible or unprecedented' social or environmental impacts."

- Those are very serious charges. The World Bank would surely defend itself against them. It would say, correctly, that development requires change.

- The World Bank *did* need to change its mission and focus. Is Dr. Kim going about it the right way? Given the long-term effects of World Bank programs, we'll have to wait and see.

Regimes

- Nobel laureate Sir Angus Deaton argues that aid to developing countries props up corrupt governments. The money either goes to political cronies or else just temporarily buys off the poor so that they continue to support the government.

> *The job of reducing poverty depends not so much on providing capital but instead on eliminating protectionism and corruption.*

- New York University economics professor William Easterly shows that from 1970 to 2000, the relation between aid and economic growth was very strongly negative. Academic research, as well as

some of the World Bank's own research, finds that the job of reducing poverty depends not so much on providing capital but instead on eliminating protectionism and corruption.

- We know which institutions and policies create prosperity: economic freedom, particularly free markets; the rule of law; competition; and open access to political power—as opposed to a more narrow elite holding all of the power. The puzzle is this: Why don't the leaders of poor nations just adopt those policies?

- One answer is that politicians' time horizons typically are too short. A policy might be great, but it might take 4 years to begin helping. If you're a politician facing reelection before then, then you're likely to think twice.

- Douglass North, in his book *Structure and Change in Economic History*, states that the chance of regime change rises when political leaders introduce many economic reforms. Even if things would otherwise have turned out well, the odds are that *someone* will lose out along the way, and they won't be happy about that. If they can get enough political power, then they can replace the leader.

- Economists Raquel Fernandez and Dani Rodrik argue that it's very hard for the beneficiaries of such reforms to find any economic gains that they can specifically attribute to those reforms. Moreover, at the time the reforms are under consideration, nobody is sure exactly who will win, and by how much.

- The threat of violent regime change is devastating for development. Here, "violent regime change" means a violent coup or revolution, such as Fidel Castro's guerrilla war against the government of President Fulgencio Batista. New leaders mean a new set of powerful elites. These elites tend to expropriate the property of the existing owners.

- In the United States, Britain, Germany, and some other developed democracies, people can start a business or add a room to their home and be pretty sure they can keep it. Property rights are fairly well respected. That's simply not the case in Rwanda or Somalia.

- In the book *The Dictator's Handbook*, the authors Bruce Bueno de Mesquita and Alastair Smith say that politically powerful people don't worry too much about the "interchangeables," meaning regular people. They care about the "essentials." These are the people who are critical to winning and holding political power.

- It seems as if there are millions and millions of interchangeables and very few essentials. But Bueno de Mesquita and Smith say that compared to dictatorships, the number of interchangeables compared to the number of essentials in democracies is actually relatively low. That means that an elected politician in a democracy must satisfy the masses of the broad electorate, too—or at least enough to get elected.

- Moreover, political scientist Barry Weingast says the frequency of violent regime change tends to increase as poverty levels increase. Without additional information, we can't be sure which causes the other, and we can't rule out that a 3rd factor causes both.

The Spectrum

- The United States is the world's longest-lasting regime, having remained intact since 1789. It's prosperous, too.

- What about at the other end of the spectrum? Take the poorest half of the countries since World War II. Of that group, the median time period between violent regime

changes is just 7 years. And remember, that doesn't count the number of times that a violent coup failed.

- In middle-income countries—like Mexico and India—violent regime changes are less common, but they still occur once every 12.5 years on average.

- About 90% of the countries in the world undergo violent regime change a couple of times in a generation. The remaining 10% of the countries—the richest ones—have a median time between regime changes of 60 years. That's about 5 times longer than in middle-income nations.

The United States is the world's longest-lasting regime, having remained intact since 1789.

- The stable havens are countries like the United States, Denmark, the United Kingdom, Germany, France, Japan, Finland, Sweden, and Norway. They are stable—and rich.

Unstable Regimes

- In an unstable regime, even a benign ruler has trouble eliminating corruption and making other changes for the better. Weingast gives the example of Mexico's state-run oil company, PEMEX. PEMEX is much less efficient than a private company would be. It has too many employees and they make too much money. Without government protection, the company would have to become more efficient to survive.

- But if the government tried to reform PEMEX, then it would have to face down these employees, who are essentially a separate army and who have great political power.

- PEMEX could just about shut down the country, according to Weingast. Given the status of the Mexican armed forces, it's

not clear whether the outcome of a confrontation between the Army and PEMEX would be better than the status quo.

- The drug lords are much worse. They operate outside the law, and yet they have such strong fighting forces at their disposal that the government can't always control them. The Mexican government lacks the power to prevent the corruption and violence that hampers economic growth.

- What's a policymaker to do, given the violence trap? Consider Somalia, or some other failed state, like Rwanda or Iraq. You might think that building democracy, creating institutions like the rule of law, and instituting free markets would be the way to go.

- But democracy fails if people refuse to accept the outcome of elections. Free markets help, but why invest or start the long process of building a business if someone's going to trash it in a few years? The more immediate need is peace and stability. Without peace and stability, then democracy, the rule of law, and free markets simply can't work.

Suggested Reading

Barnett and Finnemore, "The Politics, Power, and Pathologies of International Organizations."

Bueno de Mesquita and Smith, *The Dictator's Handbook*.

Cox, North, and Weingast, "*The Violence Trap*."

Danaher, *Fifty Years Is Enough*.

Deaton, *The Great Escape*.

Dubner, "Hacking the World Bank" (podcast).

Easterly, "Can Foreign Aid Buy Growth?"

———, *The Elusive Quest for Growth*.

Gran, "Beyond African Famines."

Kim, Millen, Irwin, and Gershman, eds., *Dying For Growth*.

Nelson, *The World Bank and Non-Governmental Organizations.*

North, *Structure and Change in Economic History.*

North, Wallis, Webb, and Weingast, eds., *In the Shadow of Violence*.

Powell, *Out of Poverty*.

Stark, *The Victory of Reason*.

Steil, *The Battle of Bretton Woods*.

Swanson, "Why Trying to Help Poor Countries Might Actually Hurt Them."

Questions to Consider

1. What is the best way to determine the will of the people? Do you believe that it's even possible to do it?
2. How can international economic institutions ensure compliance with their decisions?

LECTURE 9

GROUP CHOICES: ROCK, PAPER, SCISSORS

University of Chicago political scientist John Mearsheimer paints a grim picture of international institutions. Writing in MIT's journal *International Security*, his central conclusion is that institutions just can't do much to influence state behavior. And without influence, they can't promote stability or promote economic cooperation and prosperity. Part of the problem is enforcement. Another is the way people and states make decisions when they are in groups.

Rules

- Regarding group choices, James Buchanan—the winner of the 1986 Noble Prize in economics—says unanimity is the correct measure, at least for justification purposes, but that unanimity is impossible.

- The next-best thing would be to have unanimity on the rules. The point is that people, when choosing in groups, do not choose outcomes. They choose rules. They then agree to abide by the outcome of those rules.

- If we're lucky, then politics is boring. A group of people discuss the rules, then set the rules, then follow the rules, and finally are bound to accept the result of the rules. Otherwise, we end up with Carl von Clausewitz's famous "continuation of politics by other means." That is, war.

Information

- Groups need information about members' preferences to make a decision. One option for gathering information is to use prices: How much are you willing to pay for something?

- Groups can't or won't do that. Instead, they use some sort of voting to gather information about who wants what and how much they want it.

- International economic institutions do the same thing. Members of the International Monetary Fund never begin with a formal vote on an aid package. They start by gathering options from group members: "What do you think we should do about this particular problem?" "How about you? What do you think?" This doesn't work as well as a price system for gathering information, but sometimes it's all institutions have.

Lewis and Clark

- Political scientist Michael Munger and his son, Kevin, tell a fascinating story about the Corps of Volunteers for Northwest Discovery, also known as the Lewis and Clark expedition. During the winter of 1805, the expedition was approaching the Pacific Ocean, near what is now the state border between Washington and Oregon.

- *The Journals of the Lewis and Clark Expedition*—edited by Gary E. Moulton—recounts entries from the explorers' journals.

Their situation was dire: They were cold, wet, and running out of food while in a storm.

- The expedition had 3 choices: Go north, south, or inland. What to do? This expedition was not a democracy. It was a military unit. Lewis and Clark were captains and nobody else was an officer.

- But Lewis and Clark didn't rely solely on their authority. They called for a vote. Why? We'll never know for sure. But speculating helps us gain some insight about how leaders of groups reach decisions and gain compliance.

- One explanation is that Lewis and Clark didn't have a strong preference or perhaps disagreed with each other. Maybe they called a vote to gather information to help them decide.

- A second explanation is that Lewis and Clark wanted the rest of the expedition to feel that they had contributed—that their opinions were taken seriously.

- A third explanation is that Lewis and Clark had done their homework before calling for the vote. Maybe they learned that a majority would support what they wanted to do. So they called a vote to make it look like it was a group decision. That way, more members would accept it.

Good leaders rarely lose votes. If they need to make an unpopular decision, they make it.

- Suppose Lewis and Clark did have a strong opinion, and when they canvassed the group they'd instead learned that the majority opposed their plans. Do you think they would still have called for a vote? It's doubtful: Good leaders rarely lose votes. If they need to make an unpopular decision, they make it. They might explain their decision, but they don't try to fool people into thinking that it was a democratic choice representing the will of the group.

- Votes called just for show hurt compliance later. Compliance is especially important in an example such as the Lewis and Clark expedition.

- If 4 men go off on their own, they probably will die. They can't repel an attack, and a small group is unlikely to have the specialized skills in hunting, fishing, building fires, navigation, building shelter, and even primitive medicine you'd need to survive in the wilderness in winter.

- The remaining group is less likely to survive, too. A group of 36 is way better than a group of 4, but a group of 40 is better than both.

- The actual result of the Lewis and Clark vote was close. It's easy to conclude that by choosing when to call a vote, or even whether to have a vote, the expedition's leaders controlled the outcome of that vote.

- Setting out for Fort Clatsop, in Oregon Country, won. It's possible, though, that if the group had first narrowed the choices to 2, then they would have chosen some other course. It depends on voters' second choices out of the 3.

Condorcet's Paradox

- The 18th-century French mathematician and philosopher Marquis de Condorcet devised something called Condorcet's paradox. Condorcet's paradox boils down to rock-paper-scissors.

- Here is a significant example from mathematics expert Christopher Scott Vaughen: In July 1956, the 435 members of the House of Representatives included 232 Democrats and 203 Republicans. Back then, northern Democrats and southern Democrats often went their separate ways.

- One such case was federal funding for school construction, legislation known as HR 7535, or the School Construction Aid Bill. Before the vote, an amendment to provide funding only to districts that favored integration in the schools was introduced. That set up 3 options: Fund all schools, fund only schools that promoted integration, and no federal funding at all.

- The northern Democrats' first choice was to provide funding only to schools that promoted integration. Southern Democrats wanted funding for all schools. Republicans preferred to leave funding to local jurisdictions, and wanted no bill at all.

Good leaders rarely lose votes. If they need to make an unpopular decision, they make it.

- If the Republicans couldn't get their first choice (to provide no federal funding at all), then they would prefer the amended bill—to provide funding for integration—over the original one to fund everybody.

- If northern Democrats couldn't get their first choice—to fund only the schools that promoted integration—then they would prefer the original bill over no bill at all.

- If southern Democrats couldn't get their first choice—to fund all schools—then they would prefer no bill at all rather than the amended bill to fund only integrated schools.

- Congressional rules specified that the lawmakers first had to vote up or down on the amendment. The amendment to provide school funding only to districts that favored integration passed with the support of 203 Republicans. That's because the Republicans couldn't vote in the first round for their preferred choice of no bill at all.

- The 203 Republicans were joined by 116 northern Democrats who were able to vote for their first choice of targeted

funding. The 116 Southern Democrats also got to vote for their first choice—no bill at all—and they lost.

- In the actual vote, including the backroom deals and party desertions, the pro-funding vote was 225–192.

- Next, Congress voted on the bill with the approved amendment. This time, the southern Democrats were stuck choosing between their second and third choices. They voted for no bill at all rather than support funding only for integrated schools. The amended funding bill should fail, 319 to 116. The actual vote was tighter, but the bill was still rejected, nevertheless.

- Consider what the results might have been with a slight rule change. If we redo the voting process under rules that first pit the amended bill against no bill, then we get an entirely different outcome.

- It's harder to make the case that "the will of the people" is reflected in a vote that produced a first choice for only 116 of 435 of the members of Congress. People say the majority rules and accept the result. But sometimes the winner is whoever gets to set the rules in the first place. That's not necessarily the same as the will of the people.

Refusal

- What happens if people refuse to accept the outcome of a vote? The political scientists Michael and Kevin Munger say that institutions are brittle. If they break, they shatter.

- Members of international institutions usually accept group decisions. But not always. How do international economic institutions win compliance? Short of violence, is it even possible to enforce their decisions?

- Xinyuan Dai, an associate professor of political science at the University of Illinois, says that compliance varies from one country to another. That suggests that something within individual countries determines compliance. It's not the international institution, and it's not the particular decision that institution makes.

- Dai realized that even within a country, some groups inevitably gain from an international agreement while others do not. If a government complies with a free-trade agreement, then consumers and domestic exporters gain, while other domestic industries will struggle to compete with foreign producers.

- Let's say an agreement introduces new pollution regulations. The people in favor are probably not the ones bearing the direct costs of the agreement. The people opposed, though, are the ones who have to retrofit their coal-fired power plants with pollution controls or pull the plug on a line of vehicles and design a new fleet to replace it.

- It's easier to fool the people in favor of the agreement. A government can easily become lax on inspections and enforcement while saying that it's meeting all of the agreement's terms.

- It's much harder to enforce the agreement and fool the groups that are opposed to it. If someone retrofits their power plant, then it's impossible to convince them that they didn't do it, or that it really didn't cost all that much.

- Three things about this concept are critical for international institutions, including economic institutions.

    1. Because a government's ability to remain in power depends on compliance, then competing domestic interests have a real say in compliance.

2. International institutions can increase compliance by releasing information, making it harder to fool pro-compliance interest groups. It also gives legitimacy to their efforts.
3. Dai's work is a warning to institutions that make deals with totalitarian regimes. Short of revolution, these regimes have no fear of being turned out. They also control the media, making it easier to keep the populace uninformed about compliance.

- Domestic constituencies matter. By collecting and dispensing information, international institutions can enlist those constituencies as part of a decentralized enforcement system.

- Joel Trachtman, a professor at Tufts University, takes Nai's ideas a step further. Yes, he says, domestic politics is a key compliance mechanism for international institutions. But he adds that the nature of that process can make for strange bedfellows.

> *If a government complies with a free-trade agreement, then consumers and domestic exporters gain, while other domestic industries will struggle to compete with foreign producers.*

- One state might have a powerful constituency that cares a lot about the human rights policies in a second state. The second state might not have any particular fidelity to human rights, but it has its own powerful constituency that cares a lot about free trade with that first state.

- At first glance, these constituencies have nothing to do with each other. In fact, though, they represent an opportunity for international cooperation.

- The constituents of the first country push for a stance in favor of human rights and the constituents of the second

push for free trade. There's a deal that can make both happy, if they can negotiate an agreement.

- Imagine a third country that—like the second—doesn't care much about human rights, but would very much like to get some cheap loans from the World Bank.

- If the country with an interest in human rights can help arrange such a loan, then we now have 2 countries willing to press for compliance with a human rights deal: the first country that advocates human rights and the second country, which is willing to embrace human rights in exchange for free trade. They line up against the third country that doesn't care about human rights but really wants some cheap loans.

- International institutions can help to broker such complex deals—and also win compliance by uncovering such diverse coalitions.

Suggested Reading

Dai, "Why Comply?"

Dreher, Sturm, and Vreeland, "Development Aid and International Politics."

Levy, "European Acid Rain."

Mearsheimer, "The False Promise of International Institutions."

Moulton, ed., *The Journals of the Lewis and Clark Expedition*.

Munger and Munger, *Choosing in Groups*.

Voeten, "Clashes in the Assembly."

Vreeland, and Dreher, *The Political Economy of the United Nations Security Council*.

Questions to Consider

1. What is the best way to determine the will of the people? Do you believe that it's even possible to do it?
2. How can international economic institutions ensure compliance with their decisions?

LECTURE 10

THE UNITED NATIONS: A LEAGUE OF ITS OWN

The United Nations, based in New York City, rose from the ashes of its failed ancestor, the League of Nations. The League of Nations was an outgrowth of the Treaty of Versailles, which had marked the formal end to World War I. It was formed by 42 nations in 1920, but it ceased after failing to prevent War World II. On January 1, 1942, President Franklin Delano Roosevelt and British Prime Minister Winston Churchill jointly announced the formation of a new institution to take the League's place. Joined by 26 governments around the world, FDR stated that the United Nations would be dedicated to ensuring "life, liberty, independence, and religious freedom, and to preserve the rights of man and justice."

The United Nations' Formation

- With the announcement of the new institution, the Allies agreed to continue the fight against the Axis powers, and they agreed that no nation among them would unilaterally agree to make peace.

- World War II wasn't the time to bring a peace-focused entity into existence, and the UN charter wasn't signed until June 26, 1945. This organization had 51 members when it was formed on October 24, 1945, and today comprises 193 members—virtually every nation in the world.

- The United Nations' first resolution came on January 24, 1946. The general assembly resolved to work toward the peaceful use of atomic energy and to eliminate weapons of mass destruction. That resolution still has a long way to go.

Missions

- Since its first peacekeeping operation in May 1, 1948, the United Nations has been engaged in peacekeeping missions at a rate of more than one a year—more than 70 of them, at last count.

- Of about 16 current peacekeeping operations, 9 of them are in Africa. Another 5 are in the Middle East or in Eastern Europe. Only 1, Haiti, is in the Western Hemisphere.

- The United Nations is a massive institution, with more than 100,000 uniformed personnel. It runs 11 major programs and funds, like the United Nations Children's Fund (better known as UNICEF).

- Among its 15 specialized agencies, some are huge international economic institutions like the World Bank and the World Health Organization. These are autonomous agencies, but the United Nations says it shares "special relationships" with them.

- The United Nations' annual budget exceeds $5 billion a year, and that doesn't include an additional $8 billion for peacekeeping operations, either. Where does the United


Headquarters of the United Nations, New York City

Nations get all of that money? The answer is that each country is assessed an amount based on a formula.

- Brett Schaefer, a fellow in international regulatory affairs at the Heritage Foundation in Washington, says the minimum share of UN expenses allocated to each member has shrunk to levels that are far below tiny. In 1974, the minimum was 0.04%. Today, it's 0.0001%. In contrast, the United States alone pays over 22% of the expenses. Each state gets 1 vote, so countries like Samoa get a lot of bang for their buck.

Parts of the United Nations

- When people think about the United Nations, they usually think of the General Assembly. The general assembly is its main deliberative assembly. All 193 members participate and have 1 vote each.

- The General Assembly handles the general items, leaving details and action to smaller groups. It discusses questions, makes recommendations, initiates studies, considers reports from subgroups, and approves the budget.

- The General Assembly defers to a sub-group, the Security Council, on discussions and actions of the Security Council. The General Assembly won't even consider a topic if the Security Council is working on it.

- The International Court of Justice is the judicial organ of the United Nations. It consists of 15 judges. The general assembly and the Security Council elect judges every 3 years, and judges can serve up to 3 terms.

- UN rules state that the judges must be from different nations, and they normally represent common law, civil law, and socialist or communist law, which are the major legal traditions in the world. The 5 permanent members of the

Security Council—China, France, the Russian Federation, the United Kingdom, and the United States—each have a judge.

- In principle, the International Court of Justice settles legal disputes between nations, and Chapter XIV of the UN charter authorizes the Security Council to enforce rulings. The problem is that this is subject to veto by any one of the 5 permanent members of the council.

- The other 10 members of the Security Council are elected to serve 2-year terms. Regional caucuses nominate nations, and the general assembly votes to approve membership.

The Korean War

- The dubious honor of being the United Nation's earliest use of force falls to what we now call the Korean War. This bloody conflict claimed about 5 million military and civilian lives. On June 25, 1950, North Korean troops launched a surprise attack on South Korea. Prompted by South Korea and the United States, the Security Council met that same day and approved military intervention.

- Why didn't the Soviet Union—a staunch ally of North Korea at the time—veto the resolution? The answer is that it wasn't present. The United Nations had recognized Taiwan as the official government for China, and the Soviets were boycotting the United Nations in protest.

- Was the UN's intervention good or bad? One the one hand, 5 million deaths, massive destruction, the continued poverty of the millions of Koreans unlucky enough to live north of the 38th parallel under communism, and continued hostilities say there must have been a better way.

- On the other hand, had North Korea overrun South Korea, even more people would have suffered poverty and

starvation. Combat deaths might have been more or fewer. We can be confident, though, that had the Soviets vetoed intervention, then the United Nations would have been viewed as all talk and no action.

Torture

- On December 10, 1948, the United Nations produced the Universal Declaration of Human Rights. Perhaps as a sign of bureaucratic problems yet to come, the 8-page document—about 1800 words—took almost 2 years to produce. That's only about 17 words per week.

- Things haven't gone as smoothly as hoped. Rulers of some nations aren't that interested in the rights of their citizens. Torture is an example: Who could possibly balk at signing the United Nations' Convention against Torture (CAT)?

- Those would be countries that plan to use torture and countries that simply do not want to surrender sovereignty. Democracies that don't torture are most likely to sign and ratify agreements against torture. A few democracies don't sign, and those tend to be the ones that use torture the most.

> *In principle, the International Court of Justice settles legal disputes between nations, and Chapter XIV of the UN charter authorizes the Security Council to enforce rulings.*

- James Vreeland, a professor of international relations at Georgetown University, notes that among dictatorships that don't torture, none signed. Among those that do torture, the more they torture, the more likely they were to sign. The idea is that totalitarian dictatorships are happy to use torture if it meets their ends.

- Helen Fein, a researcher on genocide writing in *Human Rights Quarterly*, pointed out that interest groups that have at least some political power can pressure a dictator into concessions.

- One concession these dictatorships can make is the gesture of entering into the Convention Against Torture. An example is Augusto Pinochet in Chile. After multiple parties were legalized under his dictatorship in 1987, Pinochet signed the CAT, which was ratified within a year.

Abuses

- The United Nations deserves some ill will. One can make the argument that it's just a few bad apples who spoil the batch. One can also make the case that the good the organization does outweighs the bad. That doesn't mean that we can ignore the abuses, though.

- UN abuses can be broken into 2 categories: economic and physical.

- For a typical economic abuse, consider Zimbabwe. Longtime president Robert Mugabe approached the United Nations in February 2016, seeking $1.5 billion a year for food. Mugabe said global warming had caused crop failures, leading to widespread hunger.

- *Investor's Business Daily* called it a shakedown. It cited the state-run newspaper *The Zimbabwe Herald* as saying that even if global warming isn't the problem now, it will be soon.

- The problem with Mugabe's argument is that while food production had dropped 9% since 2004, in nearby Botswana, food production had jumped 29% during the same period.

- The problem of hunger in Zimbabwe traces to the year 2000, when Mugabe seized farmland for his political cronies. The result? Total corn and wheat production fell from about 1.8 million tons in 2000 to about a third of that by 2010. Since then, harvests haven't gotten much better. Mugabe, though, wanted to be first in line for a handout from the United Nation's Green Climate Fund, created during the Paris Climate Change Conference in 2015.

- Turning to physical abuses, writers and scholars from websites like Hotair.com to legacy media outlets like the *Washington Post* have exposed revolting stories of violence and sex abuse perpetrated by people on the United Nation's payroll, who are supposed to be serving as peacekeepers.

- UN leadership has admitted—among other things—food-for-child-sex scandals on its watch. When such abuses were uncovered, there was almost no accountability for those responsible. According to UN Secretary-General Ban Ki-moon, UN peacekeepers allegedly committed 68 cases of sexual assault in 1 year alone.

- Georgetown’s James Vreeland and German economist Axel Dreher make the case that even the Security Council has been politicized. For example, until then–Secretary of State Hillary Clinton visited Togo on January 17, 2012, no person in her position had ever been to Togo before. Why then, and not before?

- The answer is that Togo had just been elected to the UN Security Council a couple of months earlier for a 2-year term. Clinton herself said, “When you look at the voting dynamics in key international institutions, you start to understand the value of paying attention to these places.”

The United Nations Today

- The United Nations today isn’t what Roosevelt and Churchill had in mind. They envisioned an international organization built around the United States and its mostly European allies, with several countries in the Western Hemisphere included for good measure.

- When the United Nations turned 70 a few years ago, Matt Thompson, an editor of The Atlantic, wrote an assessment of how well the institution had aged. His conclusion: “Not too well.”

- Ron Prosor, Israel’s ambassador to the United Nations at the time, said that the United Nations was a wonderful institution, with great promise at its inception several decades earlier. The 51 early members were a coherent group. Today, however, fewer than half of the 193 members are democracies by the United Nations’ own definition.

- This means that a big majority of members are unfamiliar with deliberation and voting. Prosor concluded that “this once great global body has been overrun by the

repressive regimes that violate human rights and undermine international security."

- He also identified a more fundamental problem: The institution tends to focus on nations. That doesn't sit well with tribes and ethnic groups. Examples include the Kurds in Turkey, Syria, and Iraq; and breakaway groups in the former Yugoslavia and Czechoslovakia.

- As people increasingly identify with racial, ethnic, and religious groups, instead of as citizens of a nation, the United Nations has an increasingly difficult problem on its hands. The large number of tribal conflicts throughout the world suggests this isn't going away any time soon.

Suggested Reading

Associated Press, "'Bestiality' Claims by Rights Group against Peacekeepers in Central African Republic."

Chapman and Reiter, "The United Nations Security Council and the Rally 'Round the Flag Effect."

Downs, Rocke, and Barsoom, "Is the Good News About Compliance Good News About Cooperation?"

Dreher, Sturm, and Vreeland, "Development Aid and International Politics."

Lim and Vreeland, "Regional Organizations and International Politics."

Fein, "More Murder in the Middle."

France-Presse, "Whistleblower Who Exposed Food-for-Child Sex among Peacekeepers Resigns over UN 'impunity.'"

Hathaway, "Do Human Rights Treaties Make a Difference?"

Hollyer and Rosendorff, "Why Do Authoritarian Regimes Sign the Convention Against Torture?"

Hurd, *After Anarchy*.

Investor's Business Daily, "Mugabe First To U.N. Trough In Global Warming Shakedown."

Kirkpatrick, "U.N. 'Mugging' Fails."

Knapton, "Elderly Face NHS discrimination under New UN Death Targets."

Schaefer, "America, We Pay Way Too Much for the United Nations."

Sieff, "The Growing U.N. Scandal over Sex Abuse and 'Peacekeeper Babies."

Thompson, "The United Nations in a Post-Nation World."

Voeten, "Clashes in the Assembly."

Vreeland, "Political Institutions and Human Rights."

Yasutomo, "The Politicization of Japan's 'Post–Cold War' Multilateral Diplomacy."

Questions to Consider

1. Has the United Nations outlived its usefulness? Why or why not?
2. If you were designing the UN today, with a clean slate, what would be the essential features you would incorporate?

LECTURE
11

EXCHANGE RATES AND THE GOLD STANDARD

Why can't the entire world use just one currency? The United States has 50 states, each with its own taxes and its own budget, yet people in all 50 states use US dollars. Why can't 50 countries, which also have their own taxes and their own budgets, use the same currency? This lecture takes a look at that question as well as other topics involving international exchange rates and the gold standard.

Common Currency?

- Back to the question of why different countries can't use the same currency, as US states do: In principle, they could. In practice, such an arrangement is doomed to fail. The reason is that an umbrella organization—the United States—controls the US currency.

- California can't print dollars. Neither can New York. The only organization that can print money is the United States. That means that if California or New York wants to spend a lot, then it has to tax a lot. It can borrow, but eventually it has to tax get the cash to repay the borrowings.

- If a country has its own currency and wants to spend more than it taxes, then it can just print yen, or pesos, or whatever its currency happens to be. In the long run, that's inflationary, but those new yen or pesos can pay for groceries or a road just a well as existing ones can.

- That leads us to our first rule of thumb, which is: "No common currency without a common fiscal policy." The second rule is: "No common fiscal policy without a common electorate."

- The Eurozone violated both of those rules. There are rules that forbid governments from running large deficits relative to the rest of the Eurozone, but Greece was only the first to prove those rules were toothless.

- Maybe Greek voters would have chosen a different fiscal policy if they had been part of a common electorate for the entire Eurozone, but they weren't. They went their own way.

- The price of a currency relative to the US dollar is called the exchange rate. Given that Americans who import Japanese goods have to pay in yen, and Japanese who import American goods have to pay in dollars, the exchange rate is a big deal. For example, it can change the number of dollars an American needs to buy a Japenese car by 20% or more.

- That begs a question: Should these rates be allowed to find their own level or should they be managed?

The Plaza Accord

- Here is an example of attempts to cooperate to manage exchange rates: After his 1979 appointment as chairman of the Federal Reserve Board, Paul Volcker began a program of high interest rates, designed to stop the rampant inflation that was plaguing the nation.

- Inflation fell sharply. One side effect, though, was that people around the world wanted dollars to earn those high rates. To get dollars to invest, they sold their pounds, francs, and yen to buy dollars. This pushed up the dollar relative to those currencies.

- By 1985, the dollar had appreciated about 50% from its 1980 value. That made US products expensive and foreign products cheap. That was great for US consumers, who could now buy lots of good stuff. It was bad for US producers, who couldn't sell as much stuff to foreigners because their products now cost too much.

The price of a currency relative to the US dollar is called the exchange rate.

- Enter politics: American exporters like Caterpillar push politicians to intervene, either to drive down the value of the dollar, or worse, to block imports directly. US importers like Walmart try to prevent that. By 1985, Congress was feeling the pressure and considering trade restrictions. Discussions with foreign leaders about cooperating to drive down the dollar began.

- The result was the Plaza Accord. Five nations—France, West Germany, Japan, the United States, and the United Kingdom—agreed to coordinated currency intervention with the goal of driving the value of the US dollar down relative the Japanese yen and German Deutsche Mark.

- The Plaza Accord definitely did succeed in driving down the value of the dollar. That, in turn, made it easier to export US goods and harder to import German goods. The US trade deficit with Germany fell, as the Plaza Accord intended.

- The trade deficit with Japan proved to be stubbornly resistant. The accord did make it harder for Japan to export

goods, though. Those now-cheapened US dollars couldn't buy as much Japanese stuff as before.

- This pushed the Japanese economy toward recession. The Bank of Japan responded with easy-money policies. A few years later, people were complaining about a Japanese asset price bubble. The asset bubble helped to cause a serious crisis that lasted long enough to earn the name Lost Decade.

- The Plaza Accord had another unintended consequence. Market participants decided that the accord would push the dollar lower than official targets. They sold dollars now, hoping to repurchase them later, after the price fell still further.

- By 1987, five Plaza Accord signatories, plus Canada, felt it was necessary to discuss how to halt the dollar's continuing slide. They met in Paris, and the Louvre Accord was the result. Signed on February 22, 1987, the Louvre Accord essentially stood in the path of the Plaza Accord.

- Does all of this mean that the Plaza Accord worked, or that it worked too well, or that it failed? Even the proponents of international cooperation agree that managing currencies is hard.

War and the Gold Standard

- War is not healthy for international economic institutions. Leland Crabbe wrote a paper called "The International Gold Standard and US Monetary Policy from World War I to the New Deal" for the *Federal Reserve Bulletin*.

- Crabbe said that the gold standard relied on gold-standard countries allowing holders of their currencies to convert them to gold on demand, and to allow gold to flow across nations. That is difficult during a world war.

The writer Leland Crabbe asserts that the international gold standard worked well before World War I, and its success relied to a great extent on the stability of the British pound.

- Why leave the gold standard during wartime? The answer is that tanks and submarines are expensive. There's no time to raise taxes to pay for them. The only solution is to print money, whether it's backed by gold or not.

- That means inflation. Compared to fighting a war empty-handed, inflation is the lesser of 2 evils, but it's still an evil.

- After hostilities ceased in 1918, both winners and losers need to get inflation down to acceptable levels. As in the past, most countries planned to return to the gold standard.

- In April and May 1922, leading economists and policymakers from more than 30 countries and dominions met in Genoa, Italy, to discuss the international monetary system. All European governments set returning to the gold standard as their major objective. They needed to slow or even stop inflation, and returning to the gold standard would accomplish that.

- Some economists, though, worried that too many nations returning to the gold standard in too short of a period could trigger deflation.

- That's because the quantity of gold, along with a technical feature called the cover ratio, determines the money supply. An insufficient gold supply means an insufficient money supply, and an insufficient money supply means deflation.

- Two of the leading proponents of this view were Britain's Ralph Hawtrey and Sweden's Gustav Cassel. They prompted attendees to adopt conference resolution number 9, which recommended that central banks cooperate to centralize and coordinate the demand for gold.

- The idea was the countries' demand for gold wouldn't get out of hand all at once. Genoa participants agreed on recommendations, but nothing could force nations to follow the recommendations.

> *Some economists worried that too many nations returning to the gold standard in too short of a period could trigger deflation.*

- Thus, the return to the gold standard had a shaky foundation. Throughout the 1920s, the number of countries on the gold standard increased from a handful in 1920 and 1921 to 43 in 1929.

- Cassel continued to warn of the growing gold shortage, and argued for alternatives, including lower coverage ratios. The idea of lower coverage ratios was that nations wouldn't have to hold as much gold for each unit of currency. But Cassel's warnings went unheeded, for the most part.

After the War

- International loans and reparations from World War I were a big part of the problem with returning to the gold standard—and for international economics in general.

- The United States had loaned $10 billion to the other Allied nations. The victorious Allies had imposed the equivalent of over $30 billion in reparations on the Axis powers. The Axis powers, devastated and depopulated from the war, were in no position to pay.

- By late 1923, the situation was no longer tenable. The Reparations Commission—a group established by the Allies after the war—formed yet another committee to find a solution. Charles G. Dawes was the right person for the job.

- Dawes and his committee gave it their best shot, and in April 1924, the Dawes Plan was implemented. Everybody gave up something. Germany's annual reparation payments were reduced; exactly how much wasn't specified. Germany surrendered some control over its economy to foreigners. France and Belgium returned the Ruhr to Germany.

- Foreign banks—mostly US banks, using US investors' money—loaned Germany $200 million to try to get the German economy moving again. The Dawes Plan worked so well, according to an entry in the *Encyclopædia Britannica,* that "the stringent controls over Germany could be removed and total reparations fixed." The Nobel Committee agreed: In 1925, Dawes shared the Nobel Peace Prize for his efforts.

- However, the Dawes Plan spread the pain over several years and several countries, but didn't alleviate much, if any, pain. US banks lent Germany money. Germany used it to pay reparations to France and the UK. France and the UK used the German payments to stay current on their war debts to the United States. That means the United States

made new loans to new creditors so that old creditors could pay back old US loans.

Mistakes

- Dartmouth College economist Douglas Irwin shows that both France and the United States made mistakes that contributed mightily to the collapse of the gold standard, and ultimately, to the Great Depression.

- The short story is that both countries forced deflation on the rest of the world by not playing by the implicit rules of the gold standard. Other nations eventually were forced to abandon the gold standard to halt domestic deflation.

- Irwin calculates that the United States and France held 5% more of the world's gold reserves than it should have in 1929. That number climbed to 9% in 1930, and to almost 13% in 1931. And that's about when the gold standard began to collapse.

- France had suffered rampant inflation in the early 1920s, and was in no mood to let that recur. France's Monetary Law of 1928 required that all French reserves be held as gold, and put other restrictions on the Bank of France, too.

- Britain's John Maynard Keyes—admitting that he had not taken Cassel's warnings seriously enough—called for an international gold conference regarding the problem. Even had his plea been effective, it was too late. Britain left the gold standard days after his comments were published.

- Charles Calomiris, a professor of financial institutions at Columbia Business School, says the problem with coordinating a return to a gold standard was that the initial conversion rates were way off market values.

- That's painful to fix, but it's still fixable. Had countries followed the rules of the gold standard, decreasing their money supplies when gold flowed out, and increasing their money supplies when gold flowed in, then problems would have eventually subsided.

- The fundamental problem was that national governments controlled gold flows. Letting market forces do the job would have worked best, but a binding international agreement to follow the rules would have worked, too.

- The key word is *binding*. National governments respond to domestic constituents much more than market forces or international rules.

Suggested Reading

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Mundell, "A Reconsideration of the Twentieth Century."

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Questions to Consider

1. Why are changes in currency exchanges rates so important?
2. Why do countries on the gold standard almost always leave it during wars? What are some problems with returning to it after a war?

LECTURE 12

WHAT CAUSED THE GREAT DEPRESSION?

In 1929—just before the Great Depression—the unemployment rate in the United States was 3.2%. By 1933, unemployment had soared to 25%. Total industrial production declined by about half. The banking system collapsed: Between 1929 and 1933, over 10,000 banks in the United States failed. As trust in the banking system evaporated, people turned to cash. As a consequence, the money supply in circulation fell by 31%. The Great Depression was among the most transformative chapters of the 20th century. Even Americans steeped in limited government accepted vastly more government intervention in their lives. And the fallout moved well beyond the United States. If the Great Depression had never happened, we wouldn't have as many international economic institutions as we do today.

Keynes

- What could cause such a world-wide economic disaster as the Great Depression? The economist John Maynard Keynes's original model of business cycles and growth held that insufficient demand causes recessions and depressions. If people start hoarding cash—or don't buy enough stuff for

any reason—then sellers don't get paid enough. That means they can't buy enough. And we end up with less demand for goods and services.

- Keynes's *General Theory*—published in 1936, when people were scared and weren't investing much—holds that spending creates income. His ideas certainly fit the times.

- You might ask why producers don't cut their prices so that people start buying. That's a great question. In a Keynesian economy, quantities—not prices—are adjusted.

- In Keynes's defense, you can make the case that prices (or wages) are sticky downward. If that's true, the result is unemployment. But even if you buy the story that prices are sticky, they aren't fixed.

- Sticky things don't move immediately with a nudge, but they do move with a big enough tug. Keynes recognized this, but held that prices just don't adjust appropriately.

- If you want to apply Keynes's original model for a longer period, then you have to assume that the price system is broken. If people aren't willing to save—and interest rates don't rise—then we should ask why. If people aren't willing to spend and prices don't fall, then we have to ask why.

- The Keynesian model alone can't explain the Great Depression. No single theory can. Too much went on before—and during—the Depression, all around the world.

The Gold Standard

- Most experts agree on most of the factors that caused the Depression. The disagreements are over how much each factor contributed to the mess. *The Concise Encyclopedia of Economics* states that the Great Depression was a

worldwide phenomenon. Germany, Brazil, and the countries of Southeast Asia were engulfed by 1928. By early 1929, the Canadian, Polish, and Argentinian economies were shrinking. The United States joined that list by the 3rd quarter of 1929.

> *In 1914, the currencies of most developed countries were on the gold standard.*

- Barry Eichengreen, a professor of economics, and MIT economist Peter Temin lay most of the blame at the feet of the international gold standard. In 1914, the currencies of most developed countries were on the gold standard. That means the value of a national currency was pegged to (and interchangeable with) a specific amount of gold.

- If 2 countries do that, then they've also fixed the exchange rate between their national currencies. One big advantage is that, done right, the gold standard keeps prices stable. Another is that businesses know how much they'll have to pay to get the currency they need to buy foreign products.

- The big disadvantage is there's no obvious economic reason for the exchange rate to be fixed at any given level. If an economic force (like inflation) signals that the pound should be worth less, then interventions to keep it at the same level distorts transactions.

- During World War I (and afterward), the United States remained on the gold standard—and didn't change the value of the dollar relative to gold—even as the rush from other countries to print money sparked inflation and drove lots of gold to banks in the United States.

- Dartmouth College professor Douglas A. Irwin—an economist by training—says the British chancellor of the exchequer at the time, Winston Churchill, returned Britain to the gold standard before prices had declined to the market equilibrium price.

- John Maynard Keynes denounced the decision in his pamphlet, "The Economic Consequences of Mr. Churchill." The decision meant that eventually Britain would face a bad choice: It would either have to devalue the pound (which would force a pay cut on all workers and make savers instantly poorer) or else experience deflation while on the gold standard.

- On the other side of the Atlantic, the United States now held about 40% of the world's gold reserves. So, when other countries moved to return to the gold standard, there simply was not enough monetary gold in the rest of the world to support countries' currencies at the existing exchange rates.

- When France returned to the gold standard in June 1928, it undervalued the franc. Because francs were cheap, French labor was cheap, which made French exports less expensive in foreign currencies. On the flip side, foreign goods were too expensive for French residents. French exports rose, and French imports fell.

- That meant that the world ended up owing France money, and shipping gold to France. Irwin says that the Fed's decision to tighten US monetary policy in 1928 was a massive error that helped trigger the depression. But he adds that France's accumulation of world gold reserves deserves a large helping of blame, too. He points out that France's share of monetary gold rose from 7% in 1927 to 27% in 1932.

- Because the United States and France were holding so much gold, other countries on the gold standard didn't have enough. And they had to stem their gold outflows. The problem was that decreases in the domestic money supply—although sometimes necessary to combat inflation—also tend to restrict economic activity. That's precisely what happened. And the size of the contraction was more than policymakers bargained for. The Great Depression was under way.

The Tariff Act of 1930

- George Mason University economist Thomas Rustici argues that The Tariff Act of 1930—more commonly known as the Smoot-Hawley Tariff—was a much bigger reason for the economy's collapse than was a return to the gold standard.

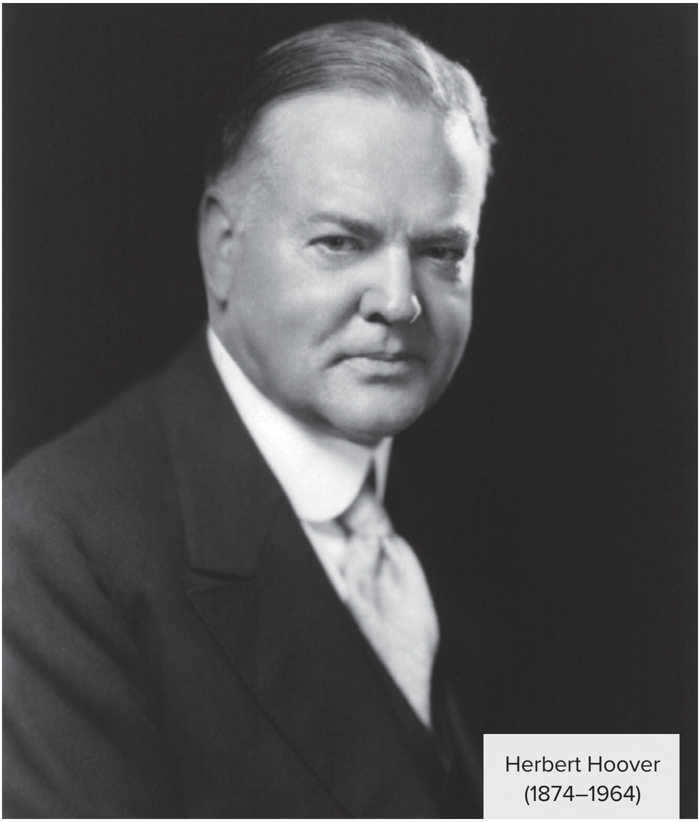
- The legislation had the effect of raising US tariffs on more than 20,000 imported goods. Many economists agree that Smoot-Hawley was a factor in causing the Depression but say that it played only a small part.

- However, Rustici argues persuasively that the Smoot-Hawley tariff bill caused people to change their expectations of what would happen in the future. And that caused other things to change, until the effect of the tariff bill was much larger than the 5–7% share of the economy that international trade represented at the time.

- In the 1928 presidential campaign, the Republican candidate (and winner) Herbet Hoover ran on the promise of farm tariffs. He lost control of the bill, though, and it morphed into much, much more expansive legislation allegedly "protecting" American businesses in general.

- Several Smoot-Hawley tariffs were big. The tariff on Canadian hard winter wheat jumped 40%. The one on glass instruments for scientific uses climbed from 65% to 85%. A fair guess is that overall tariffs rose somewhere between 40% to more than 50%.

- Almost immediately after Hoover's inauguration on March 4, 1929, the tariff bill under consideration expanded to other goods. The House of Representatives passed Smoot-Hawley in the fall. And on October 21, 1929, 16 senators who had been blocking the legislation caved and accepted tariffs supporting industries in their own states in exchange for votes in favor of the bill.



Herbert Hoover (1874–1964)

- That's the day the stock-market slide began. By October 29, the market had lost a third of its value. Smoot-Hawley wasn't yet law, however. The House and Senate bills were different, so they had to be reconciled before a bill could go to President Hoover for his signature.

- Bumpy negotiations between the House and the Senate continued through November and December 1929. In May 1930, a letter signed by 1,028 US economists told President Hoover to veto the legislation. "Do not sign this bill!" they warned.

- At one point, *The New York Times* even proclaimed Smoot-Hawley dead. Stocks regained all but 8% of their previous decline. Unfortunately for investors, the market reversed course and lost 22% as reconciliation legislation advanced in spring of 1930.

- Despite having campaigned on farm tariffs, Hoover himself opposed the massive mutation that finally reached his desk in the form of Smoot-Hawley. Yet Hoover signed the bill into law. He had promised to sign a much smaller bill but felt that "promises made shall be promised kept."

Retaliation

- Other countries raised their own tariffs in retaliation after the bill became law. Here's a list:

    1. On June 18, 1930, the tariff takes effect. Switzerland talks of boycotting American products.
    2. On June 30, Italy raises its automobile tariffs.
    3. On July 22, Spain passes the Wais Tariff of 1930, primarily aimed at auto imports from the US. Automobile imports to Spain from the US fall 94% in 3 years.
    4. On September 17, Canada passes the Canadian Emergency Tariff. Most tariffs jump by half.
    5. On November 20, 1931, Great Britain passes the Abnormal Importations Act. This lets the Board of Trade double import duties on any and every product it chooses.
    6. In February 1932, Great Britain doubles down with the Import Duties Act, which adds another general tariff of 10%.

- International trade promptly, and predictably, crashed. In more than 20 countries, imports and exports fell at least by double digits between 1930 and 1931, with an average decline of more than 27%, according to data from the National Industrial Board. In the United States, exports cratered 37%, while imports fell by 32%.

- Today, most experts agree that cutting taxes is a good way to combat economic downturns. They disagree about how to cut taxes, yes. Some argue that sending people cash is the way to go. Others support cutting tax rates.

- Regardless, you'd have a hard time today finding people to support a tax increase during a recession. But in the 1930, the nation wasn't used to running budget deficits like it is now. President Hoover recommended a big tax hike late in 1931 to close the then-current one. Congress approved the tax increase in 1932.

- This reduced personal exemptions and sharply increased tax rates. The lowest marginal tax rate more than tripled, from 1.125% to 4%. The highest marginal rate more than doubled, from 25% to 63%. Households had less disposable income, spent less, and had less incentive to work. This made the economic contraction worse.

Other Factors

- The response of the Federal Reserve System and other central banks to the contraction was also a big mistake. They didn't foresee how bad the economy would get.

- During the collapse, central banks thought that they were running an accommodative monetary policy. They weren't. They were selling securities and draining funds from the banking system at precisely the time they should have been doing the opposite.

- A big reason that the money supply was collapsing was that banking was collapsing: 10,421 out of about 25,000 banks failed in 3 years. The money supply declined by 29%.

- A big reason behind banking failure was that banks weren't allowed to branch in those days. They had all of their eggs in

one geographic basket, so if a local economy tanked, so did the bank. That's particularly important because during the Great Depression, a lot of the pain was packed into specific areas and industries. For example, agriculture in the Midwest took a beating.

- Banking didn't collapse in Canada. The Canadian system was designed differently. In particular, banks were allowed to branch. Even if the crops failed inland, fish were biting on the coast. Canada didn't have a single bank failure during the Great Depression.

Suggested Reading

Cole and Ohanian, "The Great Depression in the United States from a Neoclassical Perspective."

———, "The New Deal and the Problem of Monopoly."

Irwin, *Free Trade under Fire*.

Lyon, et al., *The National Recovery Administration*.

Posner, "A Statistical Study of Antitrust Enforcement."

Roosevelt, "Proclamation 2039."

Shlaes, *The Forgotten Man*.

Silber, *When Washington Shut Down Wall Street*.

Smiley, *Rethinking the Great Depression*.

Questions to Consider

1. What forces caused the Great Depression?
2. Which of those forces are problems today?

LECTURE 13

"HIGGLEDY PIGGLEDY": F. D. R.'S STIMULUS PLAN

The causes of the Great Depression are complex. But how and why we recovered is even tougher to understand. Experts can't even agree on when the recession ended. Consider, for example, 2 measures of the unemployment rate: the official rate and an adjusted rate that includes temporary jobs, which typically is lower. Both reached 23% in 1932; the official rate peaked in 1933 as the adjusted rate fell. So, did the Great Depression end in 1932 or 1933, when the unemployment measures peaked? Was it in 1937, when the adjusted unemployment rate returned to single-digits before temporarily spiking again? Or was it 1941, when the official series reached single digits? If you don't count wartime, which naturally pushes unemployment rates down, then you'd say the Depression didn't end until around 1947. Whatever date you choose, you can find data and experts to support your conclusion. What's clear, however, is that the Depression wasn't one long slump—nor was the recovery smooth.

An Equation

- Macro economists focus on an equation that is descriptive and may be prescriptive as well. It's MV = PQ. M is the

quantity of money in the economy. V is the velocity of money. M times V is the total amount spent in the economy.

- The money buys good at a price, P, and it buys a quantity, Q, of them. Both M times V and P times Q equal the total amount spent in the economy.

- That equation why economists are so concerned about the money supply. When the money supply collapses, something has to give. Velocity is relatively stable compared to the price level and the quantity of goods. So if the money supply drops, then prices—or the quantity of goods—must fall accordingly.

- Several prominent economists—among them Milton Friedman and Anna Schwartz—have produced research showing that the collapse of the money supply was a big factor in causing the Depression, and that recovery didn't happen until the stock of money recovered.

- Most experts now accept that mistakes in monetary policy were the primary cause of the Depression and that correcting those mistakes was the primary factor in the recovery. They also agree that other factors and policy mistakes contributed to the unprecedented length of the economic turmoil before the United States, and other countries, returned to a sound economic footing.

- Some of those mistakes occurred during the Hoover administration and some during the Roosevelt administration.

Wages and the New Deal

- Among the countries that didn't suffer as much as the United States, were Canada, Great Britain, France, and much of northern Europe. Among other differences, they typically had better banking institutions than the United States. And

most left the gold standard earlier than the United States did, allowing them to devalue their currencies and, therefore, reduce real wages.

- Lower wages help because employers hire more. Wages had fallen about 10% during most previous recessions that lasted only one or two years. Wages didn't fall in the early parts of the Great Depression, though. Economists at the time correctly noted that this was atypical.

- Why hadn't wages fallen? In part, because presidents Hoover and Roosevelt did their best to make sure that they didn't. Hoover had seen first-hand the effect of wage cuts during the economic downturn of 1920–1921. But instead of realizing that lower wages were a tonic to get people back to work and restore the economy's health, he saw only the temporary human suffering. As a result, he preached a high-wage policy afterward.

- The New Deal isn't a plan FDR conceived of by himself. It evolved from conflict between the institutions of the presidency, Congress, and the Supreme Court. Congress enacted 15 major pieces of legislation establishing New Deal agencies and programs in the space of just 100 days, but many more came afterward.

Federal Spending

- Proponents of federal stimulus spending fall into 2 camps. The first camp says that it's the spending itself that matters. The idea is that the people working have more income because of the make-work program, which they spend to buy stuff, which lets the seller buy stuff, and so on. The economy hums along.

- The second camp has a better case for federal stimulus spending. They say spending matters, but the work done

because of that spending is also important. Repairing a broken-down bridge might be a very good idea. But building a bridge to nowhere might not be a good idea.

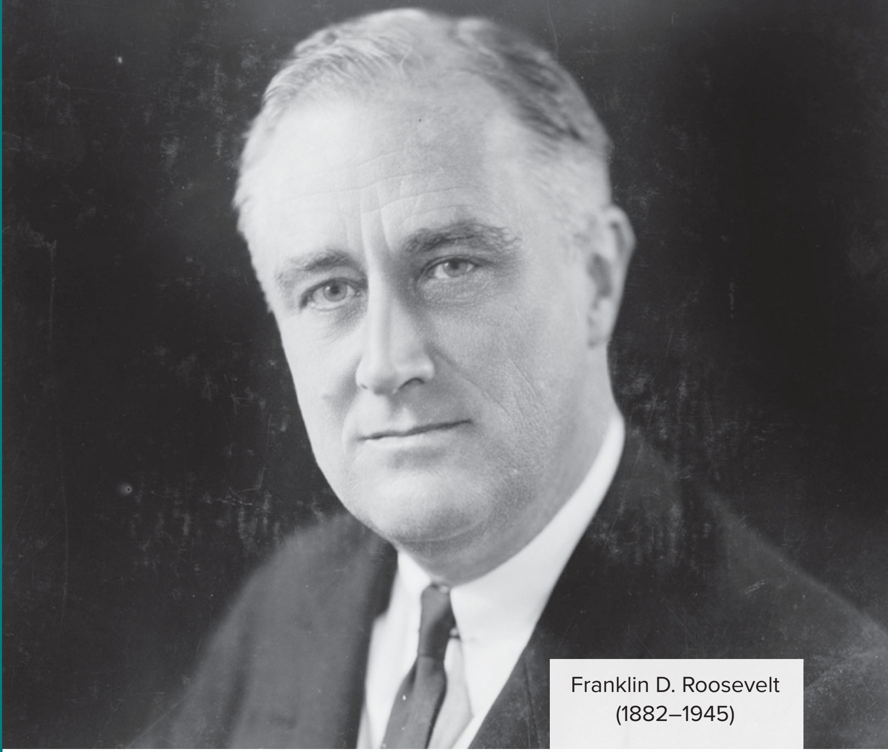
- True, the people who built the bridge to nowhere were sitting around doing nothing, and building the bridge gave them pay and something to do. But then the country lacks the steel, concrete, fuel, and other resources that went into making the bridge

- Another problem: Policymakers have to find useful projects that fit the skills of the people who are out of work. And who is most likely to be out of work? It's not dentists or engineers; it's people with few skills. It's very hard to find good projects for fiscal spending, and mistakes make the situation worse than doing nothing.

- On the bright side, the Tennessee Valley Authority—created by the federal government during the Depression—developed hydroelectric power throughout parts of the South that previously had only spotty access to it. Roosevelt's Works Progress Administration produced as many as 8.5 million jobs to build bridges and employ professionals like nurses and artists.

Lower wages help because employers hire more. Wages had fallen about 10% during most previous recessions that lasted only one or two years.

- The New Deal produced many such programs. But did they work? Roosevelt's own Treasury secretary, Henry Morgenthau, said in May 1939, "We are spending more than we have ever spent before and it does not work."



Franklin D. Roosevelt
(1882–1945)

Bank Measures

- Two days after taking the oath of office, Roosevelt announced Proclamation 2039, which ordered a bank holiday. Banks were closed the week of March 6 to March 10, 1933.
- Simultaneously, Roosevelt asked Congress to approve the Emergency Banking Act, which gave the Treasury Department authority to reopen solvent banks and to assist others that were under water. Congress approved it quickly.
- Government intervening to close private businesses is a horrible idea in general, but this was a situation that called for triage: Stop the bleeding, then worry about the rest of the problem.

- The following Sunday evening, Roosevelt held one of his famous radio fireside chats. And he convinced 60 million listeners that the institution of banking in the United States was secure and the crisis was over. A politician—anyone—being able to do that today is almost unimaginable. In turn, investors relaxed a bit.

Damage

- We now know that some key New Deal programs prolonged the Depression and weakened the recovery. Economists Harold Cole and Lee Ohanian argue that Roosevelt got bad advice from one of his main economic advisors, the retired Brigadier General Hugh Johnson, whom Roosevelt appointed head of the National Recovery Administration. Johnson argued that the economy had expanded during World War I because the government had ignored antitrust laws in place at the time.

- The "solution" was the formation of the National Recovery Administration that Hugh Johnson led, and which administered the National Industrial Recovery Act.

- The National Industrial Recovery Act imposed "codes of fair competition" on each industry. Each industry was encouraged to limit competition.

- Most industry codes kept businesses from producing as much as they wanted or investing as much in plant and equipment. Firms could charge no less than a government-mandated minimum price. If a business wanted to cut your prices to sell more, it had to tell the code authority in advance.

- The code authority would notify the competitors. Then the business had to wait. The waiting period let the code authority and competitors lean on the business to cancel the price cut.

During the Great Depression, the US government paid farmers not to work—during a time of high unemployment—and slaughtered 6 million pigs to drive up pork prices. Measures like this prompted Ogden Nash to write his famous poem, "One From One Leaves Two."

- Even tiny family businesses got into trouble for reducing prices. Amity Shlaes, author of *The Forgotten Man*, recounts the story of the Schechters. The Schechters operated a chicken business, which ran afoul of the new rules because of their prices. They were convicted and faced prison terms.

- The resulting case reached the Supreme Court, which overturned the Schechters' conviction. The National Recovery Administration was ruled unconstitutional soon after. It's hard to tell what news moves stock prices sometimes, but the Dow Jones Industrial Average began to rise about that time.

- Roosevelt doubled down on his anti-competition policies after the Supreme Court acted. The economists Ohanian and Cole document how much the administration looked on as industries continued to collude against consumers. The Justice Department cut the average number of antitrust

cases from 12.5 a year during the 1920s down to 6.5 a year from 1935 to 1938.

- Another measure was National Labor Relations Act—signed into law on July 5, 1935—which gave unions more bargaining power. The number of work days lost to strikes rose to about 28 million in 1937 from just 14 million in 1936. Unemployment was in the high teens, yet the nation suffered double the number of work days lost to strikes. Something was wrong.

- FDR changed his view of corporatism and his policies in the late 1930s. He appointed Thurman Arnold—a staunch proponent of trust busting—to lead the antitrust division of the Department of Justice.

- Federal judge Richard Posner points out that the number of new antitrust cases brought by the Department of Justice quadrupled over the next few years. The government won most of them.

War

- One theory goes that the end of the Great Depression came about in 1941, with America's entry into World War II. Wartime activity boosted the economy.

- This is an extreme example of the fiscal policy explanation. Americans weren't just digging ditches and filling them up again. They were killing people and being killed.

- The political economist Robert Higgs has an interesting idea that hasn't swayed the majority of economists as to the cause of the Great Depression, but does seem to explain part of the reason the Depression lasted so long.

- Higgs points out that if government spending on World War II ended the Depression, then the United States should

have returned to recession after the war—when government spending declined. Many economists predicted that, but it didn't happen. By 1947, when the transition from a wartime economy to a peacetime economy was nearly complete, the unemployment rate was less than 4%.

- Higgs's explanation for why the Depression lasted so long was that the business community was afraid of FDR.

- FDR prosecuted Andrew Mellon, which would be roughly comparable to prosecuting Warren Buffett today. Mellon's alleged crime was taking tax deductions that he was legally entitled to take.

- During World War II, a *Fortune* magazine poll of business executives showed that only 7% believed the United States would have a relatively free economy after the war. Slightly more than half—52%—of the polled business executives said the United States would have an economic system that would still offer many profit opportunities, but in which government would take over many public services formerly under private management.

- And 37% of the surveyed executives expected a semi-socialized society in which there was little room for the profit system to operate. Another 4% expected to face a complete economic dictatorship, such as a totalitarian government with a communist economy, or a fascist government controlling a great deal of the economy.

- Overall, 93% of survey respondents believed that the US economy would be less free after the war than before it, and fully 41% expected America to emerge from the war with an economic system radically different—and far less free—than the one in place before the war.

- After the war ended, businesses invested heavily. They needed to retool to produce consumer goods instead of

weapons. They were relieved when Roosevelt's successor, Harry Truman, set aside many of the more radical New Deal ideas that had been proposed.

- Higgs thinks this helped to restore business confidence. In 1946, civilian output rose about 30%. That remains the best economic performance in the history of the republic.

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Cole and Ohanian, "The Great Depression in the United States from a Neoclassical Perspective."

Hawley, "The New Deal and the Problem of Monopoly."

Higgs, "The Great Escape from the Great Depression."

Lyon, et al., *The National Recovery Administration*.

Posner, "A Statistical Study of Antitrust Enforcement."

Romer, "What Ended the Great Depression?"

Roosevelt, "Proclamation 2039."

Shlaes, *The Forgotten Man*.

Silber, "Why Did FDR's Bank Holiday Succeed?"

Smiley, *Rethinking the Great Depression*.

Steindl, "Economic Recovery in the Great Depression."

Questions to Consider

1. Why did the Great Depression last so long?
2. How did cooperation between government and business interests prolong the depression?

LECTURE 14

THE BANK FOR INTERNATIONAL SETTLEMENTS

The United States and European economies—particularly the German economy—were in a dangerous position in the late 1920s. Germany was staggering under the burden of billions of dollars of reparations that it owed to the victorious Allied governments after World War I. Germany wouldn't have been able to stay close to current on those obligations were it not for private lenders, many of them in the United States. As long as new cash came in, the situation was tenable. That wouldn't last forever.

Problems

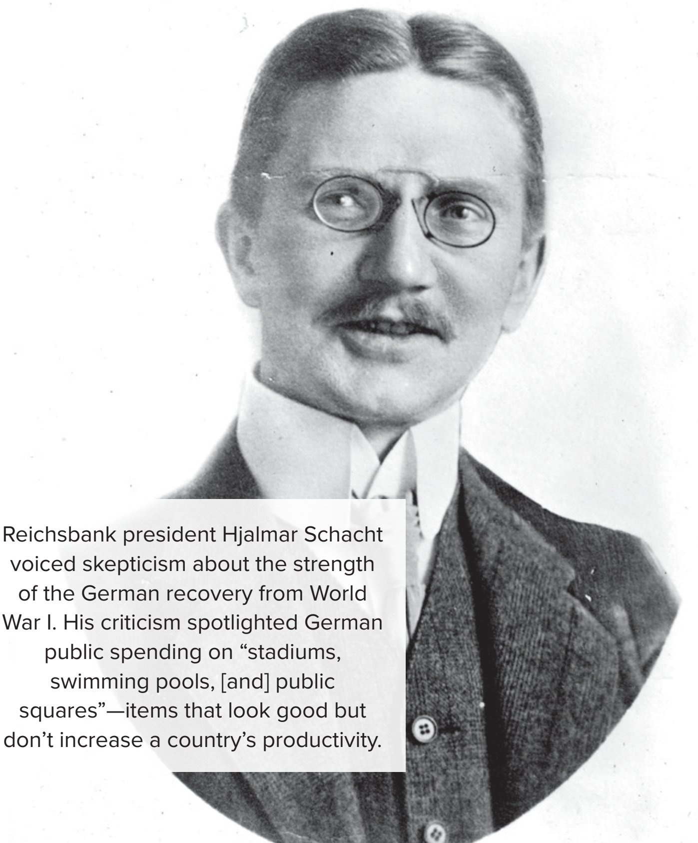
- The first concrete evidence that new problems awaited became apparent in 1928. The League of Nations' *World Economic Survey* shows that Germany had increasingly drawn on external capital sources in the post-war years through 1927 (with the exception of 1926). But the capital inflows dipped in 1928. And in 1929, they fell almost in half.

- By the end of 1930—after the US stock market crash—the availability of external capital in Germany was less than 15% of the pre-crash peak.

- Harvard's Beth Simmons says that just 2% of German government spending was devoted to servicing existing debts. Germany, rather than pay down the war debt, had begun to increase social spending.

- Before the war—and before Germany had reparations obligations—about 37% of its public funds went to social services. After the war, despite the added burden of reparations, it allocated almost 60% of public funds to social spending.

- Foreign lenders had seen enough. They sent their capital elsewhere and wanted their existing loans repaid. But Germany simply didn't have the money to do that.



Reichsbank president Hjalmar Schacht voiced skepticism about the strength of the German recovery from World War I. His criticism spotlighted German public spending on "stadiums, swimming pools, [and] public squares"—items that look good but don't increase a country's productivity.

- Forcing it to cough up the funds would bring down the economy. And Adolf Hitler's National Socialist German Workers' Party—better known as the Nazis—was already a force within Germany. The situation was delicate.

The Bank for International Settlements

- The Bank for International Settlements (BIS) was founded in early 1930 to help central banks around the world coordinate monetary and financial stability.

- This was one of the most nationalistic periods in recent European history. So why would nations surrender part of their sovereignty during a time of such strong nationalism? Simmons says the BIS was an innovation that didn't fit the geopolitics of the era.

- On the other hand, this was early in the coming era of big government. Communism, socialism, Nazism, and other collective ideologies were in their heyday.

- Simmons says the formation of the BIS was a "bargained arrangement." By that, she means that not a single government was initially in favor of creating the BIS. But a key feature of the agreement was supposed to be that Germany's commitment to repay its international debts would at least appear to be strengthened.

- The arrangement also reduced German reparation obligations. All else equal, the less you owe, the more likely you are to repay it.

- Simmons says that international lending to sovereign states is beset with a fundamental problem: Laws and rules really don't apply. When push comes to shove, barring the threat of force, no nation can make another nation do anything.

Even if both the borrower and lender agree to arbitration, enforcing a judgment is hard.

- Stanford University's Jeremy Bulow and Harvard's Kenneth Rogoff have jointly detailed the arcane dance of debt renegotiation between private creditors and debtor foreign governments.

- The first step in this dance is that the debtor threatens default. The next step is that the private creditor threatens to use its domestic legal system to make life difficult for the debtor nation.

- Bulow and Rogoff identify a subtler lever for both the creditor and the debtor. Suppose Argentina threatens to default on a loan from Bank of America. Bank of America might win recourse through US courts to disrupt Argentina's trade with the United States. That would hurt Argentina, but it could also hurt other US parties.

When push comes to shove, barring the threat of force, no nation can make another nation do anything.

- The US government might want—or need—to compensate those US parties that lose through the trade action. Both the Bank of America and Argentina, of course, would suggest that a direct payment to Bank of America on behalf of Argentina to call off the lawyers would be cheaper and simpler.

Germany's Position

- Germany's creditors had a lot at stake. About £70 million of British assets were frozen when Germany's economy collapsed. American investors also had a significant stake in Germany. Between 1924 and 1931, more than half of all foreign long-term loans to Germany were from US investors.

- Germany's debt problems didn't happen overnight, and creditors had been well aware that they were coming. For example, in 1924, the Dawes Plan reduced Germany's annual payments. But it didn't offer Germany any permanent debt relief and didn't do anything to ensure that creditors would eventually be paid.

Conception of the BIS

- One of the architects of the Dawes plan was Owen D. Young. When the Dawes Plan had outlived its usefulness, Young was appointed chairman of a committee on reparations on February 9, 1929. Young believed that no solution was possible until the German debt problem was removed from the sphere of politics and put under private, international control.

The BIS wouldn't be beholden to any nation; it would be better able to serve as a clearinghouse for international accounts, hold funds, and serve as mediator for disputes.

- Young also believed that no progress was possible on how much Germany would pay until the institutional arrangement to handle those payments was settled.

- Young conceived of the BIS as an institution for the world's central bankers, but under private business control. The idea was that because the BIS wouldn't be beholden to any nation, it would be better able to serve as a clearinghouse for international accounts, hold funds, and serve as mediator for disputes.

- The committee Young headed to advise the reparations commission submitted this innovative solution, along with a big reduction in Germany's yearly reparations payments (more than 25%), to the creditor governments for their approval.

- Not a single government supported the idea of the BIS, according to Simmons. However, central bankers in Britain, Germany, and the United States—who were charged with the task of maintaining international economic stability—felt differently.

- Without some solution, their jobs would become much more difficult, if not impossible. Private lenders, for their part, needed a stable economic system, too.

- Without private lenders having a major role in reparations negotiations, no agreement was possible. Memories of World War I were still fresh during the 1920s, and politicians of the Allied powers faced powerful domestic incentives to take a tough stand against Germany.

Bretton Woods

- World War II temporarily pushed the BIS into the background. In fact, it almost became a wartime casualty.

- In 1944, at what would prove to be a monumental gathering of government and financial officials from 44 different countries in Carroll, New Hampshire, the foundation was laid for the creation of the International Monetary Fund and the International Bank for Reconstruction and Development (later the World Bank), both in Washington DC.

- Officially known as the United Nations Monetary and Financial Conference, we know this gathering better today as the Bretton Woods Conference.

- These developments looked bad for the BIS. The IMF was clearly going to be a major international economic institution from the start. And the World Bank would eventually become one, too. The BIS's influence seemed sure to suffer from these new organizations.

- A delegate from Norway by the name of Wilhelm Keilhau proposed that the BIS be eliminated. The United States, led by Treasury Secretary Henry Morgenthau and a formidable senior Treasury Department official named Harry Dexter White, supported the move.

- European interests managed to block this assault on the BIS's survival. The decision to eliminate the BIS was officially reversed in 1948.

Success or Failure?

- Did the BIS succeed at smoothing the path to German repayment of reparations and loans and put the world on the path to sustained growth? Obviously not. The Great Depression followed and the world plunged into war a few years later.

- But we shouldn't lay the blame with the BIS. Few scholars would argue that any single thing caused the collapse of international trade, the Great Depression, or the war. And the early efforts of the BIS never really had a chance to succeed.

- Today, the idea of a supranational economic institution like the BIS isn't unusual at all. Globalism is far more advanced and popular than it was in 1930. We have the IMF, the World Bank, the World Trade Organization, the Eurozone, and so on.

- The BIS has a board of directors with as many as 21 members. That includes 6 ex officio directors: the central bank governors of Belgium, France, Germany, Italy, the United Kingdom, and the United States.

- Because each ex officio officer has the authority to appoint another member of the same nationality, that means up to 12 directors hail from 6 countries in Western Europe and the

United States. That's a majority, so the Western influence is strong.

- Despite the heavy Western influence, the BIS has 60 member central banks. All but about 5% of the world's gross domestic product is represented by their economies.

- The main office is in a neutral site: Basel, Switzerland. Hong Kong and Mexico City now have regional offices, reflecting the need for a more global presence.

- While the BIS may serve as a bank for central banks, that means it won't open accounts for private individuals or corporations. The journalist Adam LeBor says that the BIS has only about 140 customers, yet made a profit of about £900 million one recent year.

Criticism

- The BIS has had its share of critics, including LeBor. Suppose 2 countries—say, Nazi Germany and Czechoslovakia—go to war. Then, suppose the BIS receives an order for a transfer from one country to the other.

- The Nazis had invaded Czechoslovakia, and were occupying the Czech National Bank at the time of a money transfer. Nazi officials ordered the directors to approve the transfer of 23.1 metric tons of gold from the Czech account at the BIS to the German account at the BIS.

- BIS rules were clear: We are not a nation, and we are not

Despite the heavy Western influence, the BIS has 60 member central banks. All but about 5% of the world's gross domestic product is represented by their economies.

a party to the conflict. Our job is to process international financial transfers.

- LeBor takes the BIS to task, and very harshly. He says that it "was so entwined with the Nazi economy that it helped keep the Third Reich in business."
- All of that is true. It's also true that all of that is what the BIS is supposed to do. It was founded to make international transfers. If Germany got the gold by force, what was the BIS supposed to do? Start refusing transfers, depending on how the owner acquired the funds, thereby taking sides in national disputes?
- Today, Americans probably tend to make the value judgment that the BIS was wrong, given that Americans were aligned with the opposing side during the war.
- Perhaps the BIS was set up wrong, with the wrong goals, or the wrong rules for transfers. Maybe the whole idea of an international economic institution to help with international payments is bad. Or maybe an international economic institution is the best among bad choices. It's debatable.
- LeBor also dislikes that the Germans and British maintained business as usual with the BIS, more-or-less. As astonishing as it seems, the BIS was working with both the Allied and Axis powers at the same time.
- But other international institutions also played nice with warring sides at the same time. The Red Cross is a perfect example. During the war, members of the Red Cross treated wounded soldiers on both sides!
- All else being equal, the best thing to do is keep a war from starting. Failing that, the best thing to do is to stop it as soon as possible. The Red Cross and the BIS can't do either of those. What they can do, in their own small way, is reduce the damage.

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League of Nations, Economic Intelligence Unit, *World Economic Survey*.

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———, "Never Mind the Czech Gold the Nazis Stole …"

Schacht, *The End of Reparations*.

Simmons, "Why Innovate?"

Todd, "Latin America, Asia, and Russia."

Trueman, "The Young Plan of 1929."

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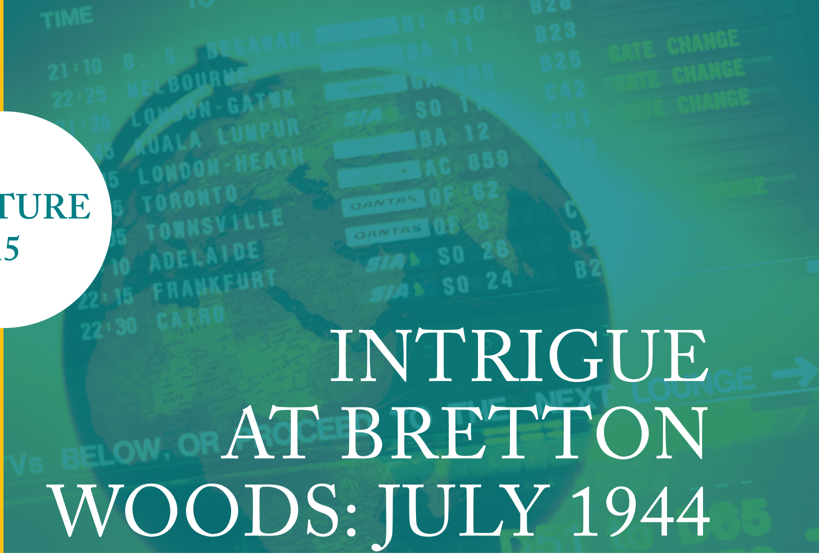
Young, "Memo to the Committee of Experts."

Questions to Consider

1. How did a major international economic institution like the Bank for International Settlements come about during one of the most nationalistic periods in history?
2. Do you think that the Bank for International Settlements helped to solve the problem of World War I reparations? Why or why not?



LECTURE 15

INTRIGUE AT BRETTON WOODS: JULY 1944

The United Nations Monetary and Financial Conference took place at a mountainside retreat in New Hampshire from July 1 through July 22, 1944. Better known as the Bretton Woods Conference, it saw delegates from 44 nations convene to set the terms of the international monetary system after World War II and to foster free trade in the post-war economy. Most people today think of the Bretton Woods era as lasting from December 1945—when the US dollar was fixed to gold an exchange rate of $35 an ounce—up to 1971, when the United States left the gold standard and adopted a flexible exchange rate. Fascinating political intrigue occurred behind the scenes at Bretton Woods.

The Problems

- The idea behind Bretton Woods was laudatory. Much of the world's economy was in bad shape before the war. Layer the most destructive war in history on top of that, and you can see why the Allied powers were worried about how life would be on the other side of the war.

- Along with the US dollar as a new international currency, Bretton Woods envisioned the creation of 2 economic institutions (the International Monetary Fund and today's World Bank) to fix some problems in international trade.

- Most of those problems had their roots much earlier, in World War I. To finance that previous war, nations had been compelled to print money, which countries can't do while on the gold standard. So Britain, France, and other powers temporarily abandoned it. Returning to the gold standard proved difficult. Picking the right amount of gold per unit of national currency is hard. Some countries—like Britain and France—picked the wrong values.

- In the early 20th century, people viewed gold as the foundation of all money. But that doesn't work if countries don't follow the golden rule of the gold standard. After World War I, the United States and France didn't play by the rules. Each failed to increase its money supply when gold flowed in.

- Some of that was just a mistake. Some of it was due to having to follow mostly unrelated domestic laws, which happened to force central banks to break the golden rule.

- The result was that France and the United States forced deflation on the rest of the world—particularly Britain—after World War I. On top of that, add in debts from the war and German reparations that couldn't be paid with Germany's shattered economy. Trade wars and currency devaluations followed.

Bretton Woods

- Bretton Woods was designed to fix these issues. The United States wanted to fix were currency devaluations relative to the US dollar. The United States felt that a relatively strong dollar would hurt its exports.

- Other countries didn't care: Some believed that if the United States exported less, then they would be able to export more.

- The United States and Great Britain, in particular, were bitterly divided over the goals of Bretton Woods. The British economist John Maynard Keynes was proposing a new unit of account, called the bancor. Individuals wouldn't carry around or even use bancors, but all international transactions would be conducted in bancors.

- Keynes proposed that a new international economic institution—to be called the International Clearing Union—would keep track of these international transactions.

- American representatives objected vehemently to the bancor. They insisted that the US dollar should have special status as an international reserve currency.

- The United States—holding about two-thirds of the world's monetary gold, and being the creditor to many debtor nations—held a strong hand. A senior US Treasury Department official by the name of Harry Dexter White managed to get the dollar named as the only currency that could serve as the equivalent to gold in international transactions. White was Keynes's main Bretton Woods nemesis.

Some countries believed that if the United States exported less, then they would be able to export more.

- Keynes came from an upper-class background and held expectations of economic greatness for himself. White came from a hardscrabble background and was an admirer of Soviet-style central planning. This was the 1930s, well before the famine and poverty that follows central economic planning became clear.

- Even had Keynes not hailed from Great Britain, nor White from the United States, they would probably still have held

completely different visions of the post-war international monetary system. At the same time, Britain and the United States also maintained distinct—and diverging—interests at the Bretton Woods Conference.

- Why would 2 nations who were close allies during both World Wars be at such odds? Britain had borrowed the equivalent of more than $100 billion from the United States during the earlier war, and hadn't repaid it yet, even as World War II was coming to a close. Further, Congress and many Americans had taken an isolationist position before American entry into World War II, with little appetite for renewing a credit line to embattled Britain.

- President Roosevelt, a skillful politician, devised something called the Lend-Lease program to soften appearances. America would give the British things they needed now, and the British would give America things they need. They couldn't give the Americans anything right away, of course, because they were embroiled in an existential battle with the Axis powers. Instead, they'd give America items after the war—or else just return the goods America had given them.

- Congress and the Treasury Department weren't fully on board. Harry Dexter White, Treasury Secretary Henry Morgenthau, and the Treasury Department laid down harsh terms that the British would have to accept after the war's end. Morgenthau later told President Truman that his goal at Bretton Woods was "to move the financial center of the world from London and Wall Street to the United States Treasury."

- To accomplish this, Morgenthau and White set 3 conditions for aid:

    1. Great Britain had to open trade access to its colonies and dominions.
    2. Britain would have to allow the conversion of pounds sterling into US dollars after the war. Conversion was to be set at

a fixed rate that overvalued the pound. Britain honored the commitment on July 15, 1947, and it lost a lot of money.

3. Britain would have to accept the US dollar as the world's dominant currency when the war ended.

- No nation would accept such onerous terms if it had any viable alternative. British economist Lionel Robbins famously—and bluntly—said, "We needed the cash."

Interplay

- Bretton Woods can be viewed as the interplay between the world's biggest creditor, the United States, and the world's biggest debtor, Great Britain. Two wars had devastated Britain's economy. Its debt-to-GDP ratio had ballooned to 250%.

- Britain hoped that Bretton Woods would set favorable terms for debtor nations. The United States wanted the terms of Bretton Woods to favor creditor nations.

- Keynes tried to make the case that countries that consistently export more than they import should face economic penalties. That would have applied most obviously to the United States.

- The US government wouldn't accept such constraints on its growing economy. They argued that their trade balances were none of Britain's business.

- Britain might have had a compelling case for some debt relief. Britain entered the war much earlier than the United States, Canada, and Britain's former colonies did. Those nations benefited from Britain's sacrifice.

- But the United States had a different perspective. Much of the American population felt that Britain had gotten itself into a mess. The United States didn't really expect the funds from

the Lend-Lease program to be repaid. But Morgenthau and White weren't going to give any more money to Britain.

- Eventually, Keynes had to accept the American's position for the most part, and that meant another loan, further indebting the empire. This was humiliating for Keynes because he previously had convinced the British government that it wouldn't have to take a loan.

- Yet, unlike many international loans, this loan was repaid. Britain made the last payment in 2006.

Tasks

- White and Morgenthau wanted the participants at Bretton Woods to accomplish 4 major tasks after the war:

    1. The Soviet Union would be brought into a permanent alliance with the United States.
    2. Germany would be deindustrialized and its economy returned to agriculture.
    3. The inevitable shrinking of the British Empire could—and would—be achieved with only minor hiccups.
    4. The participating nations would agree to establish an international economic institution that would lend money to countries that were importing more than they were exporting. That institution would become the International Monetary Fund.

- None of those pillars stood the test of time—not even 3 years.

- The British Empire didn't shrink so much as it collapsed. The Soviet Union had no intention of becoming a reliable ally to America. That meant that the United States needed a strong ally to help contain Soviet expansion. That, in turn, depended on restoring a strong, fully industrialized Germany—or at least West Germany.

- The fourth pillar of Morgenthau and White's plan didn't immediately get anywhere, either. Under President Truman, the International Monetary Fund did nothing from its inception in the 1940s through most of the 1950s.

- Truman's approach to the IMF made some sense. Countries that run large, continuing current-account deficits are just a short step up from bankrupt countries. Lending to bankrupt countries doesn't end well, if you're expecting to be repaid.

- A location like London or New York would make sense as the headquarters for 2 institutions as large and influential as the IMF and the World Bank. Big banks and other financial institutions figured to be working closely with the IMF and the World Bank, and it would convenient and cheaper to have them nearby.

- However, both the IMF and the World Bank are in Washington DC. Recall that Morgenthau wanted "to move the financial center of the world from London and Wall Street to the United States Treasury." This was purely a political

The World Bank building in Washington DC

decision, designed to transfer power from the private sector to the public sector.

Espionage

- President Truman had planned to appoint Harry Dexter White to be the managing director of the new International Monetary Fund. But J. Edgar Hoover, the director of the Federal Bureau of Investigation, wrote to Truman that he could prove White was a Soviet spy. The White family continues to deny the charge.

- Truman realized he could never appoint White as managing director of the IMF. But he didn't want to draw attention to White's behavior, either. So, he decided that he could isolate White in the position of the US executive director of the fund, rather than drive him out of the government entirely.

- In March 1946—just before the IMF's official launch—the United States government told the British that the United States really wanted to head the World Bank. And because the British and other nations had been so cooperative, the Americans would not insist on the top position in both international institutions.

- White never faced criminal charges. In August, 1948—just days after the communist defectors Whittaker Chambers and Elizabeth Bentley testified against White to the House Un-American Activities Committee—he suffered a heart attack and died. He was 55 years old.

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MaynardKeynes.org, "John Maynard Keynes—Timeline." Viewed at https://www.maynardkeynes.org/keynes-career-timeline.html.

Gareau, "Morgenthau's Plan for Industrial Disarmament in Germany."

Steil, *The Battle of Bretton Woods*.

Questions to Consider

1. What were the problems that Bretton Woods was designed to solve? Was Bretton Woods successful in solving them?
2. Henry Morgenthau told President Harry Truman that his goal was "to move the financial center of the world from London and Wall Street to the United States Treasury." That would essentially destroy the British Empire. Is that an appropriate goal for a nation to impose on an ally during a war? Why or why not?

LECTURE 16

THE INTERNATIONAL MONETARY FUND

Many have heard of the International Monetary Fund (IMF), but a lot of people aren't really sure what it does. That's not surprising, both because it's a huge, international economic institution with scores of programs throughout the world and because its mission has changed since inception to fit the world's changing economy. This lecture takes a look at the history of the IMF and its present-day purpose.

Inception

- The articles of agreement of the IMF were developed at the Bretton Woods Conference in July of 1944. These articles went into force on December 27, 1945.

- The IMF describes itself as working "to foster global growth and economic stability" and says it "provides policy advice and financing to members in economic difficulties, and also works with developing nations to help them achieve macroeconomic stability and reduce poverty."

- The organization makes loans to countries. Many of these loans are for short-term balance of payment needs for countries that "find sufficient financing on affordable terms."

- To achieve its goal of a stable international economic system, the IMF lists 3 main tasks:

    1. It collects lots of data. That's good. Policymakers can't make good choices if they have little data or bad data.
    2. It gives "practical help to members." That's advice.
    3. It lends to countries that can't pay for all of the goods they import. The IMF is particularly willing to lend to impoverished countries.

Funding

- Where does the IMF get the money to do all of this? The answer is IMF quotas, which are contributions to the fund.

- Countries joining the IMF must contribute about the same amount of funds as similar countries that are already members. The biggest contributor is the United States.

- IMF quotas doubled not long ago, bringing the US quota to the equivalent of about $125 billion, although that varies with currency fluctuations.

- The smallest member is Nauru, a tiny island nation of about 10,000 people. Nauru's quota is the equivalent of about $3 million.

- Note the phrase "the equivalent of." The IMF—as an international institution—doesn't want to deal with the potentially sticky political problem of denominating quotas in the currency of just one member.

The United States holds the most votes at the IMF, reflecting its large quota, or payment obligations.

- The IMF combines the major currencies of the world into a basket of currencies. It has to denominate amounts in an accounting unit that keeps everyone happy. It also has to determine the proportions of each currency to include in the basket of currencies, and that's another delicate political problem.

- The IMF uses a fairly complex formula to assign those proportions. The US dollar accounts for 41.73% of the basket. The euro weighs in at 30.93%. The renminbi, yen, and pound sterling account for 10.92%, 8.33%, and 8.09%, respectively.

- The IMF calls this unit of account the Special Drawing Right, or SDR for short. The value of an SDR can be computed from the weights in the currency basket, and the daily values of the corresponding currencies. On October 1, 2016—the day the renminbi was added to the basket—an SDR was worth about $1.50.

Assistance

- In plain terms—and exaggerating only slightly—countries come to the IMF when they are either broke or on their way to being broke. They've borrowed too much for too long. Any surplus funds the nation had in reserve are being unsustainably depleted or are already gone.

- The IMF expert Graham Bird lists some pertinent questions that might be asked by the IMF and by policymakers in potential borrowing nations:

  1. What conditions and restrictions will or should the IMF impose on the borrower?
  2. Who will be the winners and losers in the borrowing country, and how powerful are they politically?
  3. Will powerful international economic players view an IMF loan as a sign of desperation or instead as a vote of confidence, which will lead to still more loans from the private sector?
  4. What if things go bad and the IMF loan can't be repaid on time?
  5. Will the IMF impose draconian terms, or will it offer subsequent loans to smooth the path to repayment?
  6. When is the next election?

- In a paper titled "The IMF: Lender of Last Resort or Scapegoat?" James Raymond Vreeland offered evidence that borrowing governments use the IMF as a scapegoat.

- Take this situation: A government wants to impose domestically unpopular programs—perhaps reduced spending or higher taxes—but doesn't want to take the resulting political fallout. If the IMF insists on those policies as a condition for a loan, then political figures can get the loan but blame the IMF for unpopular policies that they wanted to enact anyway.

- Here's an example: In late 1998, Brazil's administration of President Fernando Henrique Cardoso negotiated an IMF loan of $41.5 billion to support the Brazilian currency, the real. The IMF imposed conditions. The bulk of these were federal spending cuts, mostly infrastructure spending and social security reforms.

The IMF combines the major currencies of the world into a basket of currencies. It has to determine the proportions of each currency to include in the basket of currencies.

- The Cardoso administration, had, in fact, been pushing for similar budgetary restraint for years, but with only minimal success. Now, though, Cardoso was able to frame reforms as necessary to win IMF approval.

Politics

- The IMF is a bureaucracy, and like all bureaucracies, it's political. Vreeland and 2 colleagues, Axel Dreher and Jan-Egbert Sturm, discovered that temporary members of the UN Security Council get preferential treatment from the IMF.

- As a reminder: The UN Security Council consists of 5 permanent members, including the United States, and 10 non-permanent members that are elected for 2-year terms by the General Assembly.

- Research by Vreeland and his colleagues found that these temporary Security Council members get more loans, with fewer restrictions, from the IMF than do other nations—even after accounting for various economic factors.

Scandals

- The IMF has come under fire for various scandals, ranging from lax institutional controls to sexual escapades of high-level officials.

- British journalist Jeremy Warner reported that the IMF was fleeced by Russians during the financial crisis of 1998. The IMF loaned Russia $5 billion, which promptly disappeared and found its way to Swiss bank accounts.

- Warner also suggested that the IMF lent far too much money to Greece in one of its biggest bailouts. The IMF package of $35 billion worked out to almost $3200 each for every Greek man, woman, and child. Warner floated the idea that the IMF was not trying to save the Greek economy so much as to save the principal European currency, the Euro.

The IMF established the Independent Evaluation Office in 2001, and it is insulated from the IMF's management team.

- Even internal IMF agencies, including its watchdog Independent Evaluation Office, or the IEO, have been hard on the institution. The IMF established the Independent Evaluation Office in 2001, and it is insulated from the IMF's management team.

- Not long ago, the office blasted what it referred to as the IMF's "culture of complacency." It concluded that the IMF had made an exception to bail out Greece without even informing the institution's own board of directors.

- A large sign of trouble: Three consecutive IMF heads resigned before the end of their terms. The most publicized was that of the French politician Dominique Strauss-Kahn, who stepped down in May 2011 shortly after New York police

arrested him on criminal charges of sexually assaulting a hotel housekeeper.

- The former IMF boss later settled a civil lawsuit brought by the housekeeper, and US authorities dropped charges. Even so, his acquittal by a French court 4 years later—on separate charges of aggravated pimping—did not fully lift the cloud over him.

Usefulness

- Harry Dexter White, a 1940s-era official in the US Treasury Department who had a large hand in the IMF's formation, visualized a very different role for the institution, according to Benn Steil. Steil has written an account of its early history in his book, *The Battle of Bretton Woods*.

- According to Steil, White wanted to ensure that countries running temporary trade deficits—that is, importing more than they exported—would not impose tariffs or other trade barriers to reduce those imports.

- Steil says neither White nor British economist John Maynard Keynes—who had a different approach to handling trade imbalances, and was often at odds with White—would support what the IMF has become today: a global financial fire-fighter.

- Harvard economist Robert Barro and his colleague Jong-Wha Lee found reduced economic growth arising from higher IMF loan-participation rates. Among the problems Barro and Lee discovered was that IMF loans encourage political cronyism.

- But if IMF programs tend to slow economic growth rather than improve it, then why do governments accept the help? Barro and Lee offer 3 possible answers:

1. IMF lending might hurt in the short run, but help in the long run. They say that's possible, but not very likely.
2. An IMF loan might lower output, but not by enough to offset the favorable terms of the loan.
3. An IMF loan might be good for the governments and for individual politicians who negotiate the IMF loans. It might help reelection prospects.

- The IMF expert Bird provides more information on how well the institution functions. One reason for the IMF to remain a viable international economic institution, he says, is that it might keep governments from enacting bad policies. The IMF's articles of agreement suggest as much.

- It's also frequently asserted that private capital markets don't always work very well. Private market participants might not have enough information about credit worthiness, or they might be unable to coordinate a big loan.

- These might be good reasons. Bird points out, though, the less they apply, the less the justification there is for the IMF. Capital markets today are certainly better than they were when the IMF was formed in the 1940s. Perhaps the markets are up to the job now.

- Bird also reminds us that sometimes problems can't be fixed, or they aren't worth fixing. The cure could even be worse. The IMF is run by people, and people are motivated by power, prestige, and other temptations. Agreeing that there is a problem does not mean that a big, international economic institution should try to fix it.

- Carnegie Mellon economist Allan Meltzer says that institutional rhetoric about governance and corruption offered to state leaders and representatives is not enough, and that incentives to encourage local officials to reform are also necessary.

- Meltzer says financial crises are closely connected to excessive government spending, loose monetary policies, weak banking systems, and fixed exchange rates. The solution, he suggests, is for the IMF to insist that a nation meets 5 conditions before offering international assistance:

  1. Sensible fiscal and monetary policies.
  2. A solvent banking system.
  3. Freedom of entry and operations of foreign financial institutions.
  4. Timely release of accurate information on its financial position.
  5. Floating currency (that is, no fixed exchanges).

- Meltzer says the IMF should grant automatic assistance to countries that meet these 5 criteria. Countries that do not would not get help.

- Many countries—perhaps a big majority of them—would now be incented to enact reforms on their own. And that definitely beats having the IMF try to impose reforms from outside. Governments that do not reform would essentially be announcing that they are bad credit risks.

Private market participants might not have enough information about credit worthiness, or they might be unable to coordinate a big loan.

- Meltzer acknowledges that his plan has 2 weaknesses:

  1. The IMF might relent and bail out a country it has not certified. If nations think that's a possibility, they'll have less reason to adopt reforms in the first place.
  2. The IMF must be willing to remove a country's certification if that country no longer meets the eligibility criteria. That is politically thorny.

- A third hurdle is this: What should the IMF do if a country meets, say, 4 of the 5 criteria, but can't seem to clear the last hurdle? Should it treat that country the same way as it treats a nation that meets none? Probably not. If it did, then a true basket case might not even attempt to reform.

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Powell, *Out of Poverty*.

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Warner, “IMF Heads Must Roll over Shameful Greek Failings.

Questions to Consider

1. Has the International Monetary Fund outlived its usefulness? Why or why not?
2. How should the International Monetary Fund determine which nations get loans?

LECTURE 17

THE ASIAN DEVELOPMENT BANK

Per its website, the goal of the Asian Development Bank (ADB) is "an Asia and Pacific free from poverty." The organization began operations on December 19, 1966, under Takeshi Watanabe of Japan, who served as the institution's first president. Much like the World Bank, the Asian Development Bank makes loans and grants to member nations. It offers advisory services, too. These members are governments, which are primarily—but not exclusively—located in Asia. Nineteen of the organization's 67 members are from outside Asia.

The Early Days

- Many of the 31 original member nations' economies were organized around agricultural, so the ADB focused its early efforts on rural development, including food production.

- That changed in the 1970s, when the price of oil more than doubled from under $20 a barrel to more than $40. Member countries such as Indonesia and Malaysia suddenly saw new opportunities, and the organization began to assist development of energy resources.

- During the 1980s, the Asian Development Bank continued to support energy development while expanding its mission. For example, the ADB funded environmental projects, education, and health initiatives. It also opened a field office in Bangladesh.

Crisis

- In July 1997, a seminal event—known today as the Asian financial crisis—swept through the region on a wave of currency speculation against Thailand's currency, known as the baht.
- In Thailand, the currency attacks led authorities to devalue the baht relative to the US dollar. This was followed by weaker currencies in Indonesia, Malaysia, and the Philippines.
- Capital inflows slowed, and in some instances reversed. And economies contracted. One of the most advanced economies in the region, South Korea, was brought to the brink of default.
- In turn, the Asian Development Bank moved to establish social safety nets for the poor, and extended a $4 billion loan to South Korea—its largest single loan.
- In 1999, the ADB restated its official goal from "foster[ing] economic growth and cooperation" to reducing poverty. The difference is that economic growth can help people at any standard of living, not just the poor.

The Structure

- The Asian Development Bank gets the funds for its operations by borrowing on international capital markets. Another major source of funds is member contributions, or capital subscriptions.

- Countries with bigger economies contribute more, and countries within Asia also contribute more. The United States and Japan are the biggest contributors, with about 31 percent of the shares. ADB rules mean that the biggest contributors get the biggest share of the votes on how to allocate the institution's funds.

- The Asian Development Bank provides a lot of funding to member nations—well north of $10 billion a year, in recent years, and rising.

- The Asian Development Bank's charter grants all of the institution's powers to a board of governors. The board of governors elects an operational board of directors that sets bank policies, approves loans and grants, and establishes the organization's budget.

Influence

- Daniel Lim and James Vreeland—two scholars who have extensively studied international economic institutions—say that international political power often can be traced back to economic power. Large, rich countries can buy influence.

The Asian Development Bank provides a lot of funding to member nations—well north of $10 billion a year, in recent years.

- International economic institutions can help provide cover. Lim and Vreeland say that sovereign nations use international institutions to "launder their dirty work." Most research supporting this observation focuses on the United States.

- Lim and Vreeland decided to check if similar behavior occurred in the Asian Development Bank. Take Japan,

for example. Walden Bello—a senior research fellow at Kyoto University in Japan—quotes a member of the ADB's Board of Directors as saying the ADB is (for all intents and purposes) "funded by the Japanese, controlled by the Japanese, and run by the Japanese."

- Dennis T. Yasutomo—a professor who specializes in Japanese foreign policy—suggests that countries can boost their international influence by attaining membership in international economic institutions.

- The ADB, Yasutomo says, "provides a nonpolitical façade" for "the increased politicization of" some of Japan's policy interests and influence aims. He calls it a "nonpolitical cloak" to "legitimize controversial policies, helping Japan to share the risks and the blame."

- In other research, Dan Lim and James Vreeland find evidence that less-developed Asian countries who become temporary members of the UN Security Council, thereby boosting their profile, receive larger loans from the ADB.

- One unanswered question: Why doesn't Japan just trade direct aid to poorer nations in exchange for international influence? Here are some potential reasons:

    1. The Asian Development Bank staff is highly skilled and has considerable experience with member nations. Japanese personnel can't necessarily contribute the same level of technical expertise for every member nation.
    2. International economic institutions can give nations access to additional funds that they couldn't get from individual nations.
    3. An international economic institution gives political cover. Sure, skeptics and adversaries will realize that Japan is laundering influence, but not all of them will care.

- Sometimes, Japan wants to have a voice at the table of the UN Security Council. Because Japan is not a permanent member—and is a temporary member only part of the time—it needs a proxy to speak for it.

- One can argue that Asian countries would tend to vote as a bloc in the UN Security Council, even without the ADB, because they share regional interests. But the extent of Asian unanimity is impressive: "Asian countries elected to the United Nations Security Council have never voted against Japan while Japan itself was on the Council," according to Lim and Vreeland.

- It took time for Japan to flex its economic might. Although Japan's economy had grown out of its post–World War II ruins to be the world's second largest by the 1970s, it didn't begin to exert its influence more broadly in international affairs until a decade or so later, as at the Asian Development Bank.

- Then, Japan's influence at the ADB began to decline around 2005, Lim and Vreeland contend, just as China's was rising.

- They conclude that although the United States remains a principal influence at large, global economic and political institutions, regional powers will probably take dominant roles in regional institutions such as the Asian Development Bank.

A New Institution

- China might be short-circuiting the process by starting an entirely new institution—one that it controls. In October 2014, representatives from 21 Asian nations signed an agreement to establish something called the Asian Infrastructure Investment Bank, or the AIIB, headquartered in China's capital, Beijing.

- The Asian Infrastructure Investment Bank has a narrower focus than does the Asian Development Bank and some other international development institutions.

- It focuses—as its name suggests—on infrastructure: bridges, reservoirs, roads and the like. It doesn't focus as much on funding funding poverty reduction, education, or disease control.

- The British news magazine *The Economist* puts a price tag of about $8 trillion on coming up with needed infrastructure in the region. That's somewhere between 10 and 20 times the capital bases of the World Bank and the International Monetary Fund combined.

- That's one inducement for China to take the lead on financing regional development in ways that may be advantageous to it. Another potential reason for China to raise its profile would be a reluctance to allow the United States and Japan to continue to dominate regional economies and policies.

Japan's influence at the ADB began to decline around 2005, Lim and Vreeland contend, just as China's was rising.

Criticism

- The Asian Development Bank is far from perfect. Some mistakes are understandable. The development economist Albert Keidel points out that ADB estimates of the size of the Chinese economy were about 40% too high during the early 2000s.

- One reason for this was that China had never conducted any comprehensive, accurate price surveys of its own. Keidel points out that some US government estimates anticipated

that China's economy would be larger than that of the United States as soon as 2012. Instead, it wasn't even half the size.

- If the more aggressive forecast were accurate, then China could have supported a military presence to challenge the United States much earlier than anticipated. Meanwhile, the World Bank came to argue that China was, instead, so poor that the World Bank should continue to lend to it to support economic development.

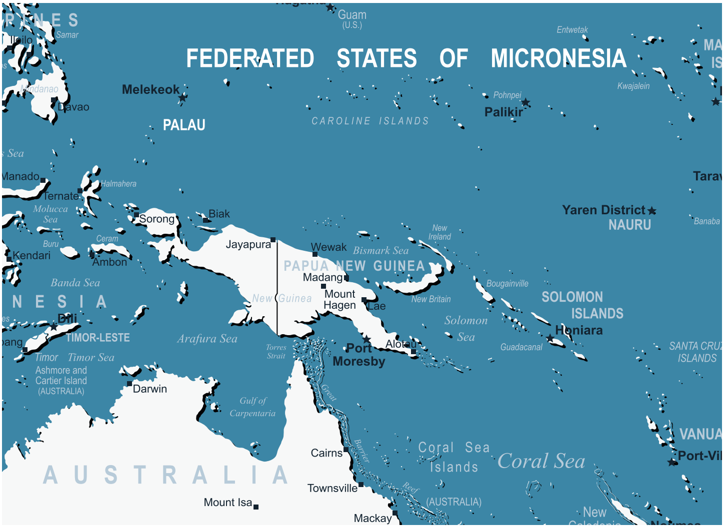
Property Rights

- Economists Dongwoo Yoo and Richard H. Steckel have studied Japanese colonization of what is now Micronesia from 1914 to 1945. Their work uses the lens that institutions like private property and the rule of law are what make nations rich, not abundant resources or cultural reasons.

- The researchers found that during Japan's colonization period, the Japanese were concerned with being able to collect property taxes. To make collections easier, the Japanese conducted a detailed survey of the island of Palau and established existing property rights, whether public or private, individual or clannish.

- World War II interrupted Japan's plans to conduct similar surveys on other islands. But after World War II, the United States took over in Micronesia. What did American courts say about the Japanese survey in Palau? The answer is that they upheld it, except they ruled that clans had no authority over private land.

- For other Micronesian islands that had not previously been surveyed by the Japanese, the US courts had no comparable records of private ownership. There was no legal title to uphold. Instead, they retreated to common law.



That meant that traditional island norms applied, and clan leaders retained the right to confiscate property.

- Now put yourself in the position of a foreign corporation or investor. Where in Micronesia do you invest? You can invest in Palau and be pretty sure that no one can confiscate your claim. Or you can invest elsewhere and take your chances.

- Much more foreign investment flowed into Palau than to other islands, according to the research by Yoo and Steckel. The point is that international economic institutions like the Asian Development Bank might do better to focus on establishing systems of private property rather than on short-term poverty relief. But doing so isn't easy.

- For example, imprecise property boundaries persist in many undeveloped countries. A way to legally identify people is also necessary. And there needs to be preparation to respond to any social upheaval that might result from new economic development.

- If you *can* manage to install the institutions of property rights and the rule of law, then the evidence suggests that prosperity is more likely to result.

- Individual citizens aren't the only beneficiaries. Governments get a bigger and more stable tax base, because land has 2 traits that make it ideal for taxation:

    1. Land can't be moved to another tax jurisdiction, unlike a business.
    2. It's permanent. A factory might become obsolete or burn down. Land will not.

The Future

- As the Asian Development Bank has grown larger and expanded its mission, it has become more like the World Bank, making loans and grants to member nations, and offering advisory services.

- Some Southeast Asian economies that have reached middle-income status (and whose leaders wish to ascend to the level of upper-middle-income countries) are now suggesting that in addition to the ADB's poverty-alleviating mission, "seeking prosperity" should be added to the institution's list of strategic objectives.

- Fast-growing India has argued that it faces "significant development challenges," and "emphasized the need for [the Asian Development Bank] to increase the volume of its assistance to the country." It did so despite the fact that income and wealth had already increased exponentially in the country.

- More recently, the United States and Canada advised the ADB to keep its focus on infrastructure development. They said it "should take a strategically selective approach" to

development and “carefully rethink its operational approach going forward.” That’s not quite asking the institution to abandon sustainable development goals, but it’s a strong hint that the United States and Canada think that sustainability isn’t the ADB’s job.

Suggested Reading

Abbott and Snidal, “Why States Act through Formal International Organizations.”

Asian Development Bank, “Our Work.” Viewed at https://www.adb.org/about/our-work.

Dreher, Sturm, and Vreeland, “Global Horse Trading.”

Keidel, “The Limits of a Smaller, Poorer China.”

Lim and Vreeland, “Regional Organizations and International Politics.”

North, *Institutions, Institutional Change, and Economic Performance*.

North and Weingast, “Constitutions and Commitment.”

Strand, *Regional Development Banks*.

The Economist, “Why China is creating a new ‘World Bank’ for Asia.”

Van Sant, “China Launches New Asia Development Bank.”

Yasutomo, “The Politicization of Japan’s ‘Post–Cold War’ Multilateral Diplomacy.”

———. “Japan and the Asian Development Bank.”

Yoo and Steckel, “Property Rights and Economic Development.”

Questions to Consider

1. Daniel Lim and James Vreeland say that sovereign nations use international institutions to "launder their dirty work." Do you think that accusation has merit?
2. The Asian Development Bank now lists reducing poverty as a goal. Financing short-term poverty relief is one way to do that. Establishing institutions to build long-term economic growth is another. Are there advantages to one over the other?

LECTURE 18

THE WORLD TRADE ORGANIZATION

According to the Fraser Institute's "Economic Freedom of the World: 2016 Annual Report," nations ranking in the top quarter of the index of economic freedom averaged per-capita GDP of $41,228 in 2014. Those in the bottom quarter of the index of economic freedom averaged a bit more than an eighth of that, or just $5,471. People can expect to live longer in a free country, too—more than 16 years longer, in fact. A big part of economic freedom is the freedom to trade with anyone you choose—on any terms—free of threats and coercion. This lecture takes an in-depth look at economic freedom as well as the World Trade Organization (WTO).

Benefits

- The economist Milton Friedman said, "The most important single central fact about a free market is that no exchange takes place unless both parties benefit." Free trade helps both parties.

Without trade, lots of useful land in Australia wouldn't be farmed.

- Marian Tupy, a senior policy analyst at the Cato Institute's Center for Global Liberty and Prosperity, offers 3 great reasons why free trade is good.

    1. Trade gets resources to the right place. For example, a truckload of grain in Kansas is just another truckload of grain until it reaches the cereal factory, where it can be turned it into thousands of breakfasts.
    2. Trade lets people specialize. Not many people have the ability or tools to repair their own cars. But they can trade the money they earn in their field with someone who's good at fixing cars. The term for that is comparative advantage.
    3. Trade expands the market for any particular item.

Mercantilism

- The British political economist David Ricardo was among the most influential economists of his era in the 18th and early 19th centuries. Ricardo was among the earliest opponents of mercantilism. Mercantilism boils down to saying that nations should run trade surpluses to accumulate gold and silver.

- Oversimplifying a bit, mercantilism says that if person A gets person B's gold, person A wins. If person B gets person A's gold, person B wins. Ricardo pointed out that this overlooks more general gains accruing from trade. If person A has plenty of cheese but no wine and person B has plenty of wine but no cheese, they can trade and both become winners.

- Ricardo also showed that trade allows specialization, which distributes goods and services better and makes the pie bigger.

- Here's a hypothetical example: Suppose that the United States can produce a pound of cheese with 1 unit of labor and a bottle of wine with 2 units of labor. In France, it takes 6 units of labor to make a pound of cheese and 3 for a bottle of wine. Both countries have 24 units of labor to allocate.

- One solution for the United States would be to allocate 16 units of labor to produce 16 pounds of cheese and 8 units of labor to produce 4 bottles of wine. France might choose to allocate 18 units of labor to make 3 pounds of cheese and the remaining 6 units of labor to produce 2 bottles of wine.

- Under this scenario, the 2 countries jointly produce 19 pounds of cheese and 6 bottles of wine. But what happens if the 2 nations specialize?

- The United States has a greater comparative advantage producing cheese than wine. It's 6 times more efficient than France in producing cheese but only 1.5 times as efficient in producing wine.

- The result from specialization is that the United States produces 24 pounds of cheese and the French produce 8 bottles of wine. Between the 2 countries, that's 5 more pounds of cheese and 2 more bottles of wine.

- If the story stops here, then the Americans have no wine and the French have no cheese. The solution is to let the citizens of both countries trade with each other.

Why Not More?

- If free trade is so good, why don't we see more of it? Consider the example of a Ford plant in Mexico versus a Toyota plant in Kentucky. Ford is an American company; Toyota, a Japanese one.

- Lots of people don't see the secondary benefits of free trade. If you're not working in that Toyota plant in Kentucky, you might not see the benefit of allowing foreign investors to buy American goods, build a factory, and hire Americans. You also won't see the workers in other companies making parts for those cars. Most important, you won't see how much better Fords are, simply because Ford has to hustle to make cars that are competitive with those Toyotas.

- Some people bemoan the changes that trade can bring, too: People who formerly lived off the land may leave their farms to become autoworkers. Living off the land the way our ancestors did does sound romantic. But consider the modern conveniences that aren't available when living off the land.

> *Countries enact protectionist policies for political reasons, not economic ones.*

- In the end, nations should say, "If we are not at war with you, then we will trade with you." Even economists who are less supportive of free trade tend to limit their disagreement to temporary conditions.

- The Spanish economist Arturo Bris says that every advanced economy has gone through a period of protectionism. He

cites, as examples, France and Britain in the 18th and 19th centuries; and the United States, Japan, and Germany during the 19th and 20th centuries.

- Bris says that less-developed countries might benefit from a limited period of protectionism. The idea is that by protecting a nation's manufacturing sector from foreign competition, it can get ready to handle foreign competition. Later, the story goes, the country can restore free trade, get richer, and advance into providing services as well as manufactured goods.

- It's true that every nation has been through a protectionist phase. But it's also true that just about every one of them has been through war, too. That shouldn't lead to the conclusion that war leads to prosperity.

- Countries enact protectionist policies for political reasons, not economic ones. A politician can win a lot of votes from labor unions and big business by shielding interest groups from competition. Consumers get inferior, more expensive products as a result.

Trade Agreements

- Duke University political scientist Mike Munger views trade agreements as a second best solution to free trade itself. If something prevents free trade, then a trade agreement is the next best choice. Not all trade agreements are desirable, though: A 400-page agreement, for example, might be overly complicated and require a stable of bureaucrats for administrative work.

- One example of how lengthy trade agreements can become is the World Trade Organization's Trade Facilitation Agreement at the Bali Ministerial Conference, better known as the Bali Package. WTO negotiations ended in December 2013.

- The idea was simple: lowering import tariffs and agricultural subsidies. That would make it easier for developing countries to trade with advanced economies. Less developed countries would get bigger markets and more jobs. Developed countries would get better and cheaper products.

- You don't need 30 pages to say that, but that's how long the Bali Package turned out to be. That isn't even particularly long, as trade agreements go. With trade agreements, simpler is better.

The World Trade Organization

- Eric Pan, the director of the Office of International Affairs at the US Commodity Futures Trading Commission, has written that the World Trade Organization in Geneva is one of 3 major international economic institutions with somewhat similar origins and goals. The other 2 are the International Monetary Fund (IMF) and the World Bank in Washington DC.

The WTO focuses more on eliminating trade barriers and less on direct aid to specific countries.

- Pan thinks that the distinguishing feature of the WTO has been its mostly successful work in promoting free trade through what he calls a "robust dispute resolution system" to enforce compliance of its decisions.

- The WTO's success at enforcing international agreements is a major economic and legal achievement. But the WTO is a fairly new international economic institution, created in 1995. Didn't Bretton Woods establish something like open access to markets, way back in the 1940s?

- Yes, and no. What we now know of as the IMF and the World Bank do share some of the goals of the WTO. But the WTO

focuses more on eliminating trade barriers and less on direct aid to specific countries.

- Specifically, the WTO grew out of 23 nations' attempts to reduce trade barriers. The General Agreement on Tariffs and Trade, known as GATT, was signed by those 23 nations in Geneva on October 30, 1947.

- GATT's support for free trade helped to foster some of the fastest growth in the history of international commerce. Yet GATT was merely a provisional agreement and organization. It was never formally adopted. Provisional or not, GATT lasted for more than 40 years. The Uruguay Round led to 123 nations establishing the World Trade Organization on January 1, 1995.

- The economists Chad P. Bown and Douglas Irwin estimate that tariffs averaged around 22% going into the first round of GATT talks in Geneva in 1947. Bown and Irwin call even 22% tariffs a considerable barrier to trade.

- Bit by bit, rounds of trade talks either reduced tariffs, expanded the number of nations participating, or both. Bown and Irwin estimate that average tariffs in the largest GATT economies by the start of the Kennedy Round of trade talks in 1964 were about 15%.

- That's a drop of 7 percentage points from 22%. That represents a one-third reduction. Bown and Irwin give a lot of the credit for the boom in international trade beginning around 1950 to this easing of trade restrictions.

Success and Failure

- Anu Bradford has studied 2 international trade deals that look quite similar in her paper "When the WTO Works, and How It Fails." One of these, the Agreement on Trade-Related

Aspects of Intellectual Property Rights—or TRIPS, for short—was a big success.

- The other, an effort to produce an antitrust agreement, didn't work at all. Countries eventually abandoned the initiative under the WTO umbrella and turned to bilateral and multilateral agreements among themselves.

- Why was there a success in one case and failure in the other? Bradford discovered 5 basic differences between the successful TRIPS and the failed antitrust deal:

  1. The nations with the most economic power unanimously supported TRIPS, but some of them didn't see a real need to reach an antitrust agreement through the WTO.
  2. Powerful domestic constituencies got behind the TRIPS agreement. In contrast, no influential local groups mobilized in favor of international antitrust agreements.
  3. The major economic powers were able to persuade or compensate other nations to gain their support for TRIPS. They managed to link TRIPS to other issues that went in favor of otherwise dissenting nations.
  4. TRIPS proponents were worried about compliance. The cost of breaking intellectual property law is getting caught and punished. That meant that the WTO, with a reasonably successful dispute-settlement mechanism, could help.
  5. Nations had alternatives to a WTO antitrust agreement, but didn't really have one for TRIPS.

- The economist Daron Acemoglu says that involving the WTO in trade negotiations can be a bad idea for this reason: Sometimes, the WTO ignores the political systems in place in member nations.

- For example, it might make perfect sense to advise a nation like France or Germany or Australia to privatize assets. Federal governments are notoriously bad at running oil companies, to cite just one instance.

- But suppose that a nation has a ruler like the late socialist dictator Hugo Chávez, who ruined Venezuela's economy. At the time Chávez took power, Venezuela was among the world's leading producers and exporters of oil. Under Chávez, things got so bad that Venezuela couldn't produce enough oil to even serve its own needs.

Countries eventually abandoned the initiative under the WTO umbrella and turned to bilateral and multilateral agreements among themselves.

- Now, suppose that in exchange for some transfer payments from WTO participants, a nation's ruler agrees to privatize its oil industry. In situations such as this, the powerful politician's family and other cronies seem to always end up getting the assets at bargain prices. The point is that the WTO must address a nation's political institutions, too.

- What's next for the WTO? Bradford thinks that governments might already have already met the more important and reasonable needs of their politically influential domestic groups. The pool of projects for this particular international economic institution isn't too deep anymore. The benefits of any given WTO agreement are uncertain, and negotiations are more likely to be contentious.

- If that's true, then the World Trade Organization might not produce too many new agreements. Instead, it might end up focusing on resolving disputes about existing agreements.

Suggested Reading

Bown and Irwin, “The GATT’s Starting Point Tariff Levels Circa 1947.”

Bradford, “When the WTO Works, and How It Fails.”

Donnan, “ Free Trade v Populism.”

Fraser Institute, “Economic Freedom of the World: 2016 Annual Report.”

Library of Economics and Liberty, “Munger on Fair Trade and Free Trade” (podcast).

Skidelsky, “The Decline of the West Revisited.”

Tupy, “Free Trade Benefits All.”

World Bank, “World Development Report, 1987.”

World Trade Organization, “The GATT Years.”

Questions to Consider

1. Why do so many policymakers oppose free trade?
2. Is the World Trade Organization at the point where it should focus on maintaining existing trade agreements and resolving disputes rather than negotiating new agreements?

LECTURE
19

THE EURO

Currency is money: paper and coins, issued by a government and accepted throughout an economy as having value. People take it for granted. People also take it for granted that having just one national currency—for example, the US dollar—is better than having several different ones. This lecture takes a look at an effort to introduce a common currency among several different *nations*—the Eurozone, in which all nations adopted the euro as their currency.

Borrowing and Institutions

- Sometimes, a small country with a weak currency—think Greece and the drachma, before the euro—can lower its borrowing costs by linking its currency to a larger, stronger neighbor (think of the German Deutsche mark). A few years before the euro replaced the drachma and Deutsche mark, Greek borrowing costs were about 3 times higher than Germany's.

- Interest rates began to converge as the date of the euro's introduction neared, and the spread was down to about 1.5 times as much when the euro was introduced.

- That begs the question of what defines an optimal currency area. An optimal currency area is the geographic area in which a single currency produces the greatest economic gain.

- The best solution would be to have it as big as possible without causing problems. The United States contains 50 different states. Each of them use the US dollar, and it works fine. How can such a big area, with so many people, make a single currency work?

- In a column he wrote shortly before the introduction of the euro in the late 1990s, Milton Friedman explained why the United States functions so well with a single currency: The country has economic institutions—meaning rules in, this case—that let the economy respond well to economic shocks.

- Friedman listed some other reasons that the 50 states could use a single currency. US citizens overwhelmingly speak the same language. Many watch the same movies and TV shows

and listen to a lot of the same music. Language and culture is largely similar.

- What makes a single currency good or bad? Friedman pointed to an economy's adjustment mechanisms—its shock absorbers. For example, Mexico and the United States have separate currencies and flexible exchange rates between those currencies.

- A shock that upsets the economic balance between the 2 nations changes the exchange rate almost instantly. That changes relative prices between the 2 nations, making it more profitable for labor and capital to move to the place where it's most valuable, sooner.

- The advantage of lower transaction costs from a common currency is valuable, but the tradeoff is that you lose a shock absorber, according to Friedman's analysis. The tradeoff usually makes sense only if the currency area has enough other adjustment mechanisms.

- Columbia University economist Robert Mundell produced much of the pathbreaking work on optimal currency areas. In his article, "Uncommon Arguments for Common Currencies," Mundell listed 4 main criteria for optimal currency areas:

    1. Unrestricted and easy labor mobility throughout the currency area. "Unrestricted" means simplified passports and common, or at least transferable, government benefits, such as pensions. "Easy" means common language and culture.
    2. Capital must also be freely mobile. Productive assets and financing need to get to where they are most needed. That requires price flexibility, including wages—the price of labor.
    3. Countries sharing a common currency need to be willing to redistribute wealth from richer areas to poorer areas to more or less bring the areas into balance. This usually

takes the form of taxation and redistribution to less-developed areas of a country or region.

4. All of the nations in an optimal currency area should have similar business cycles. Nations tend to expand the supply of money in recessions and reduce it to slow inflation. With separate currencies, Greece could inflate its economy while Germany could keep a steady course. With only 1 currency, the euro, policymakers can't do both. That means that similar business cycles are necessary for a common currency.

The Eurozone

- Jean Monnet—one of the pioneers of the Euro—would have understood the problems of the Eurozone today, according to Strobe Talbott, a former head of the Yale Center for the Study of Globalization.

- According to Talbott, Monnet would say that you can't have political integration without economic integration, and you can't have economic integration without political integration. In the Eurozone, economic integration got too far ahead of political integration.

In 1990, wealthy West Germany was united with the formerly communist, and therefore impoverished, East Germany. The German politician Peer Steinbrück estimated the cost of unification over the first 20 years at €2 trillion, with much of it being a transfer from the west to the east.

- Nations want 3 things in their international economic policy.

    1. They want free capital flow. They want to be able to take investment opportunities abroad, and to attract capital from the rest of the world.
    2. They want stability and predictability in the price of foreign currencies. Fixed-exchange rates can offer that.
    3. They want control over their own monetary policy.

- The problem is that you can't have all 3 at once, according to research by Mundell and British economist Marcus Fleming.

- The economist and columnist Paul Krugman summarized the famous impossible trinity: "A country must pick two out of three. It can fix its exchange rate without emasculating its central bank, but only by maintaining controls on capital flows." That's the Chinese way.

- Or, Krugman says, a nation "can leave capital movement free but retain monetary autonomy, but only by letting the exchange rate fluctuate." He offered the examples of Britain and Canada. The United States also follows this course.

- Finally, Krugman said that a country "can choose to leave capital free and stabilize the currency, but only by abandoning any ability to adjust interest rates to fight inflation or recession." When he was writing in 1999, his example for this later policy choice was Argentina—though Argentina later abandoned that course, and now has floating rates.

- Today, the poster child for surrendering the ability to adjust interest rates within countries is the Eurozone. Only the Eurozone as a whole can adjust rates.

- Without sovereign monetary policies, Eurozone nations remain exposed to economic shocks without a major tool to mitigate them. If that's the situation, then the countries in the

currency area had better be similar, and they'd better have similar business cycles.

- The underlying economics stated that the prospects for a successful Eurozone would be better without mixing Northern European nations with Southern European ones, or fiscally sound nations with profligate ones. But the politics insisted otherwise.

- Fred Bergsten, a founder and senior fellow of the Peterson Institute for International Economics in Washington, and Jacob Funk Kirkegaard, a research fellow there, say it was politically inconceivable to exclude Italy when the Eurozone was formed in 1999.

- Italy boasts the third-largest economy in continental Europe. It was also politically impossible to exclude Belgium. Brussels—the Belgian capital—was home to the European Union (EU) when formed in 1993.

- Why was incorporating these nations a problem? One of the criteria to help make sure that the 11 countries originally in the Eurozone were similar was the ratio of government debt to GDP. The target was 60%. Setting aside tiny Luxembourg, with its astoundingly low ratio of 7.1%, all but two of the rest were at least close, with ratios between 48% and 66%.

- The pair that wasn't close to meeting the fiscal constraint were Belgium and Italy, with debt-to-GDP ratios around 115%.

- At the time of the euro's introduction, Milton Friedman listed some other reasons why the Eurozone was likely destined to fail.

- European nations speak different languages, have different cultural customs, and maintain far greater loyalty and attachment to their own countries than to the European Union.

- Friedman also noted that regulation is more restrictive in Europe than in the United States. The regulations are different across countries, too—much more so than across US states. This means wages and prices in Europe are less flexible.

- Greece was the first country to face disaster. The Harvard political economist Alberto Alesina notes that the Greek economy seemed to be doing great during the first 10 years after Greece adopted the Euro in 2001. But that was because it was borrowing and consuming. Greece was running a 13% annual deficit, as compared to the Eurozone maximum allowable of 3%.

> *The underlying economics stated that the prospects for a successful Eurozone would be better without mixing Northern European nations with Southern European ones.*

- Greece borrows and spends too much, and the Greek government is very corrupt, according to George Mason University's Tyler Cowen. Greece has been in default on at least 1 government obligation about half of the time since around 1850.

Solutions?

- Writers, economists, and policy makers offering any number of different resolutions to the ongoing problem of the euro. All of them are painful. What follows is a look at 3.

- The first plan involves Eurobonds, which would be debt securities issued by the Eurozone. George Soros, chairman of Soros Fund Management in New York, explains the idea this way: The Eurozone would designate an agency to issue Eurobonds. The carrot is that countries in compliance could convert their national debt into Eurobonds, essentially transferring the obligation to repay to the Eurozone.

- The stick is that doing so would come with restrictions, and countries not in compliance would not only be forbidden to convert their debt to Eurobonds, but they would also lose the right to vote on fiscal decisions.

- There are doubts as to whether this would work. Cowen says that a poll on a plan similar to issuing Eurobonds showed that German citizens opposed it by about 4 to 1. Legal issues abound: It might be unconstitutional in some countries.

- Now for the second proposed solution. Fred Bergsten and Jacob Kirkegaard at the Peterson Institution say that Greece borrowed way too much and ran huge federal budget deficits. It can't repay the debt. If it still had its own currency, the drachma, then it could print money to repay the debt. This would cause its own problems like inflation, but regardless, printing money and devaluing the currency isn't an option for countries that use the euro.

- What's left? Bergsten and Kirkegaard say that if Greece were to leave the euro, its economy would collapse, and a military coup would be possible. Germany knows that its banking system would be devastated if the euro failed. It would have to issue new Deutsche marks, the value of which would skyrocket, crushing German exports.

- The European Central Bank (ECB) would fight anything that would threaten the euro, because without it, the ECB would have little reason to exist. That means that Germany and the ECB will bail everybody out.

- Cowen thinks that such a compromise will be a hard sell to the taxpayers of the fiscally sound members of the Eurozone. Even a bailout, say Bergsten and Kirkegaard, is just a temporary fix. The weaker Eurozone countries would need to reform their economies and cut government spending. Otherwise, the problem will recur.

- The Jacques Delors Institute is an independent think tank with offices in Paris and Berlin. In a 2016 report titled "Repair and Prepare," the Delors Institute outlined a third approach, which we can call the United Europe plan. That's the ultimate goal. It has 3 steps:

    1. Develop a crisis-response plan.
    2. Stimulate the Eurozone's economy.
    3. Build a true economic, monetary, and political union. That's been the goal of the European Union from the very start.

- More European integration is likely the best bet to save the euro, but that's not likely to be possible for many years, at best.

Suggested Reading

Bergsten and Kirkegaard, "The Coming Resolution of the European Crisis."

Delamaide, "Architect of the Euro Now Says It Is a House of Cards."

EconTalk.org, "Alberto Alesina on Fiscal Policy and Austerity."

———, "Cowen on the European Crisis."

Enderlein, et al., "Repair and Prepare."

Friedman, "The Case for Flexible Exchange Rates."

———, "The Euro: Monetary Unity To Political Disunity?"

Maes, "Tommaso Padoa-Schioppa and the Origins of the Euro."

Mundell, "A Theory of Optimum Currency Areas."

———, "Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates."

———, "Uncommon Arguments for Common Currencies."

Obstfeld, Shambaugh, and Taylor, "The Trilemma in History."

Sheel, "Euro Zone's Impossible Trinity."

Soros, “The Crisis and the Euro.”

———, “How to Save the EU from the Euro Crisis” (speech).

Talbott, “What Would Jean Monnet Have Done?”

Questions to Consider

1. The impossible trinity says that a nation cannot have free capital flows, fixed exchange rates, and sovereign monetary policy simultaneously. Why might a country choose any given 2 of the 3? Which 2 would you like your country to choose?
2. Do you think that the Eurozone will exist in a substantially similar form in 20 years? If not, then what will cause its collapse? If yes, then how will the nations involved resolve the existing problems with the Euro?

LECTURE 20

THE GREAT RECESSION: MISMANAGING RISK

What caused the Great Recession of 2007–2008? Ask a dozen economists and you'll get a dozen different answers. Actually, you'll get more than that, because some economists will offer 2 or more reasons. And they'll all be right. That's because, like the Great Depression, reasonable people will disagree. One expert might say, "It was a banking crisis." Another will say, "No, it was the housing crisis that led to the banking crisis." A third will say, "But it was loose lending standards forced on banks by government that led to the housing crisis." In any case, there is plenty of blame to go around, as this lecture shows.

Wall Street

- One common claim is that Wall Street types are responsible for the crash. For example, Scott Patterson, a *Wall Street Journal* reporter, wrote *The Quants: How a New Breed of Math Whizzes Conquered Wall Street and Nearly Destroyed It.* "Quants" are highly skilled people who use mathematical tools and models to address financial problems, such as how much a security is worth.

- One tool that quants used, and still use, to measure risk is called value at risk. In the late 1980s, Dennis Weatherstone, who was then the chairman of J.P. Morgan, asked this question: "What's the most we can lose by tomorrow?" Nobody had a really good answer.

- Weatherstone put his experts on the job. Value at risk was the measurement tool that they developed. Note: To answer the question, "How much can we lose?" you need to measure risk. That is not the same as managing risk. Managing risk requires you to make a decision. Value at risk just helps you generate information to help make that decision.

- Here are some key steps that can show how value at risk might go wrong. Imagine you're a quant:

  1. Pick a time horizon. Weatherstone used one day, but you could use any time interval you want.
  2. Pick a probability level that's too small to worry about. Eliminate events that are too rare to fret over, like an asteroid impact. The answer to this value at risk calculation will be the biggest loss than you can expect to see on 99 days out of 100.
  3. The next time your boss asks you the most we could lose in a day, you could answer, for example, "If we rule out events that are too rare to worry about, then the most we can lose is 12% in one day." That's far from a perfect answer, but it's way better than nothing.

- At this point, if you've done your job right, then you're off the hook if something goes wrong. It's not your job to say whether that's too much or too little risk, and it's not your job to decide what to do if somebody decides this risk level is inappropriate.

- Note: Sometimes the world is riskier than others. The red flag is if management doesn't adjust for the riskier times. Another problem: Taking a risk and surviving a dangerous event doesn't make someone right.

- And just because an event hasn't happened doesn't imply it'll never happen. That's the famous black swan problem. Until the late 17th century, Europeans hadn't seen a black swan. But it was wrong to conclude that they didn't exist. In fact, it turned out that they were rather common in Western Australia.

Mortgage Pools

- One of the greatest financial innovations of the 20th century is the mortgage pool. Banks and other financial institutions throw a bunch of mortgages into a pot and then sell claims on the earnings. It's like a mutual fund for mortgages.

- On the surface, that's a great idea. Homebuyers get better access to loans; banks can manage their risk by selling some or all of their loans; and investors get access to a new, diversified investment tool with nice characteristics.

- But we've learned that the correlations among loans in mortgage pools—how their values move together—were higher than expected, meaning the risk of the portfolio was higher than expected. Lots of institutions lost lots of money when credit problems surfaced.

> *One of the greatest financial innovations of the 20th century is the mortgage pool.*

- Bad inputs were another problem. Yale University economist Robert Shiller has constructed an index of US housing prices back to 1890. He put everything in constant dollars to take out the effects of inflation. The average annual real return on housing in the United States from 1890 through 1996 was only 0.1%.

- Now, pretend that you are the manager of a mortgage lending institution. What would you think if an underling told you that during the next 10 years, real housing prices would

double? That implies an annual return of 60 or 70 times more than it was during the previous 100 years.

- Hopefully, you would ask yourself what was really going on and decide it's a good time to reevaluate your tools and methods.

- There was also plenty of warning that defaults on mortgages were becoming a major problem. For loans made in 2003, delinquency rates after 18 months were a bit over 5%. For 2005, it was about 10%. For 2006, it was over 20%. For 2007, it was at least 25%.

- It's hard to believe that lenders couldn't have seen this coming. The key points here are that there was plenty of warning and that no risk-measurement tool forestalls problems if people ignore the signals it sends.

- UBS AG is a huge international Swiss financial services company, with headquarters in Zurich and Basel. UBS said value at risk was part of the reason it lost $38 billion from January 2007 to April 2008. UBS's postmortem said that it had become "overconfident," although risk monitors were flashing.

Collateralized Mortgage Obligations

- Sometimes, people want something that doesn't exist. If that's the case, then it's possible to make a lot of money by finding a cheap way to give them what they want. One of the most successful examples of that is the collateralized mortgage obligation (CMO).

- Here's the situation: Many financial institutions are good at arranging mortgages, but aren't well suited to hold them until they're paid off. The solution is to make, or originate, the mortgage, then sell it to some other institution that is better able to hold it for longer periods. This is very common.

- Because people sometimes pay off their mortgages early, they aren't as predictable as investors would like. Have people invested in mortgages that will last for 30 years or for 5 years? It's hard to tell.

- How can we solve these problems? Here's a step-by-step metaphorical process:

  1. Get a container.
  2. Throw a bunch of mortgages into the container.
  3. Poke a hole in the bottom of the container and put another one underneath it. Call that bucket Tranche A. Let cash from the mortgages in the container at the top flow out into Tranche A.
  4. Poke a hole in the side of Tranche A, too, so that when it gets filled up, the cash begins to overflow into another bucket below that. That's Tranche B.
  5. Add Tranches C and D, or however many are desirable.

- This dramatically reduces maturity variation. If you invested in Tranche A, then you're going to be repaid soon, and you have almost no risk. The further down you go, the more the risk that there won't be enough cash to repay you. Buyers of Tranches B and C earn higher interest rates to compensate for the risk they take with the longer maturities.

> *Sometimes, people want something that doesn't exist. If that's the case, then it's possible to make a lot of money by finding a cheap way to give them what they want.*

- Institutions have used this basic idea to transform many risky securities into new ones. Each CMO or similar structure can have different-size tranches. Still, CMOs have generally worked well since they were introduced in 1983. How can these financial instruments get institutions in trouble?

Trouble

- Risk managers of major economic institutions misused some financial models and didn't fully appreciate some risks. The Federal Reserve System made some mistakes, too. Add some bad regulatory policy, and you have at least a start for why we experienced the Great Recession of 2007 and 2008.

- The first source of trouble is easy money. In hindsight, the Federal Reserve kept rates too low for too long, from about 2002 through 2006.

- That easy money contributed to a second problem: lax underwriting standards. In the years before the crisis, a loan counted as "performing" even if a person couldn't make a payment; the lender would roll home equity into the principal. That makes sense if housing prices rise or if it's a temporary problem—a big medical expense, for example.

- But it's not a "performing" loan in the sense of the word that most people would think. If we include these loans as performing, then this would make a loan portfolio look safer than it really is.

- A performing loan has no missed payments in the most recent 90 days. That makes sense, but if the mortgage holder sells the loan, then the clock resets. That can become dicey.

- The federal government took an especially pernicious role in the decline in standards. One example is the Boston Fed. The president of the Boston Fed wrote:

  The Federal Reserve Bank of Boston wants to be helpful to lenders as they work to close the mortgage gap [a higher rejection rate for minorities]. For this publication, we have gathered recommendations on "best practice" from lending institutions and consumer groups.

- In the recommendation document "Closing the Gap: A Guide to Equal Opportunity Lending" are these nuggets from the Boston Fed:

  A performing loan has no missed payments in the most recent 90 days.

  - On credit history: "Lack of credit history should not be seen as a negative factor."
  - On down payments and closing costs: "Lenders may wish to allow … loans from relatives, nonprofit organizations, or municipal agencies to cover part of these costs."
  - On income sources: "Fannie Mae and Freddie Mac will accept the following as valid income sources: overtime and part-time work, second jobs (including seasonal work …) and unemployment benefits."

- The credit history rule asks lenders to pretend that 2 individuals, one with a credit history and one without, really are identical in every relevant way. It's doubtful that's true.

- The down payment rule mixes legitimate capital, like a bank balance, with questionable capital, like loans from builders.

- The sources-of-income rule is a mixture of the reasonable and the unreasonable. It's a mistake to include temporary sources of income when the mortgage is long-lived.

- The bottom line is that these "best practices" lead to too much debt backed by too little income. The Boston Fed even added a threat: "Failure to comply with the Equal Credit Opportunity Act or Regulation B can subject a financial institution to civil liability for actual and punitive damages in individual or class actions."

- In this example, politicians would prefer not to give money directly to people with bad credit. Instead, they encourage banks to make loans to people with bad credit at below-

market rates. Then, if the loans go bad, they bail out the banks with programs like the Troubled Asset Relief Program.

- Financial engineering by itself isn't bad, but risk managers of major economic institutions did misuse some of them. Mix in a dash of Federal Reserve error and a dose of bad regulatory policy, and you have a recipe for a good part of the reasons for the Great Recession of 2007 and 2008.

Suggested Reading

Admati, "Why the Bank Dividends Are a Bad Idea."

Admati and Hellwig, *The Bankers' New Clothes*.

Bagehot, *Lombard Street*.

Calomiris and Haber, *Fragile by Design*.

Cochrane, "Toward a Run-Free Financial System."

Day and Liebowitz, "Mortgage Lending to Minorities."

Dowd and Hutchinson, "Learning the Right Lessons from the Financial Crisis."

EconTalk.org, "Taleb on the Financial Crisis."

Eichengreen, "International Financial Regulation After the Crisis."

Humpage, "Cooperation, Conflict, and the Emergence of a Modern Federal Reserve."

Kamin and DeMarco, "How Did a Domestic Housing Slump Turn Into a Global Financial Crisis?"

Krugman, "It's Demand, Stupid."

MaHoney, *Wasting a Crisis*.

Muolo and Padilla, *Chain of Blame*.

Patterson, *The Quants*.

Rodburg and Walker III (project coordinators), "Closing the Gap."

Summers, "U.S. Economic Prospects."

Todd, "Macroliquidity."

Zaring, "International Institutional Performance in Crisis."

Questions to Consider

1. What forces caused the Great Recession? Compare and contrast these forces to the ones that caused the Great Depression.
2. Suppose that in the year 2000, you could foresee the Great Recession. Suppose further that you were able to change one rule or policy choice. What would you change, and why?

LECTURE 21

AFTER THE RECESSION: A BIGGER HOUSE OF CARDS

The recession that hit the United States and much of the rest of the world in December 2007 was severe—so severe that it has been dubbed the Great Recession. This lecture takes a look back to ask whether the institutional structure—meaning the international economic institutions and regulatory bodies—helped or hurt; whether it's stronger now than it was then; and what we've learned.

The Recovery

- There's evidence the recovery from the Great Recession was pretty good, or at least better than it would have been without strong government intervention. There's also evidence the recovery was pretty bad, or at least worse than it would have been without strong government intervention.

- Clemson University economist Gerald Dwyer and Fordham University finance professor James Lothian have pointed out that although the Great Recession of 2007 and 2008 was the longest since World War II, other recessions beginning in

November 1973 and July 1981—with durations of 16 months or so—were just 2 months shorter.

- Sylvia Allegretto, a labor economist at the University of California, Berkeley, writes: "As of February 2016, total job growth was up 3.7% (5.1 million) in the U.S. … compared to December 2007—the last business peak cycle. … [H]owever, the 3.7% job growth figure for the U.S. … happened over an eight-year period—which is weak in the context of a growing labor force." Still, that's 5.1 million jobs.

- Normally, unemployment drops rapidly after recessions. That didn't happen after the Great Recession. It took 5 years after the official end of the recession to recover the number of lost jobs.

- One might also say that the drop in the official unemployment rate masks a problem. The US Bureau of Labor Statistics calculates the unemployment rate as the number of unemployed people looking for work as a percentage of the labor force. That can drop as more people find jobs—that's good—or as more people give up and stop looking. That's bad.

- To gauge how much of the decline in unemployment is due to people just giving up, we can check the labor force participation rate. That's the percentage of the population that is either working or actively seeking work.

- The labor force participation rate was above 66% the year before the recession; it declined to between 62% and 63% since. That's a steep drop for a number that historically doesn't move much.

- Maybe the silver lining is improved productivity, which could mean that we're producing more with less. But that isn't it. Productivity has increased a little, but total US output hasn't kept up.

- The Center on Budget and Policy Priorities, which identifies itself as a nonpartisan research and policy institute, calculated at one point that the economy was underperforming by 2.2%, or about $407 billion a year.

- Federal Reserve chair Janet Yellen said that slow growth of 2% or less was about the best we could expect for a few years. That's just not very good. Growth after recessions under Presidents Reagan and Kennedy was closer to 4%.

Discussions

- Dwyer and Lothian contend that discussions about the recovery sound like discussions of the Great Depression. If you're a Keynesian, you'll say that low aggregate demand is the problem. If you're not a Keynesian, then you'll say that bad government policies have decreased incentives to work, or at least have caused so much uncertainty that people won't invest as much.

- Nobel laureate Paul Krugman—who is among the best-known Keynesians—says the problem was insufficient demand. If he's right, then the massive government spending following the recession just wasn't massive enough.

- The late University of Chicago economist Gary Becker—also a Nobel laureate—wasn't a Keynesian. He said that government meddling was responsible for the weak recovery. Among Becker's complaints: repeated attacks on American business, especially banks (which, he hastened to add, were often well-deserved); the expensive stimulus; and the Affordable Care Act, which Becker said increased the cost of providing health insurance for employees.

- Becker called the Dodd-Frank financial reform act a "complicated and a politically driven mixture of sensible reforms, and senseless changes that have little to do with

stabilizing the financial architecture, or correcting what was defective in prior regulations." He preferred lower, flatter taxes; entitlement cuts; and regulations that give regulators less discretion.

Institutions

- Walter Bagehot, writing in 1873, gave central banking institutions the recipe for stopping a crisis. According to what's now known as Bagehot's rule, the central bank should lend freely against good collateral at a high rate. The idea is that you don't want to support firms that have gone bad. But you do want to prevent sound institutions from failing due to temporary liquidity troubles.

> *Growth after recessions under Presidents Reagan and Kennedy was closer to 4%.*

- The United States' central bank, the Federal Reserve, did a great job of serving as this lender of last resort during the Great Recession. Some experts say it lent *too* freely, with one of the chief culprits being a program called the Term Asset-Backed Securities Loan Facility, or TALF.

- The New York Fed began operating TALF in late November 2008. It was authorized to make up to $200 billion in loans for periods of up to 5 years, in exchange for securities that pooled newly originated consumer and small business loans. One problem: the 5-year term. Central banks aren't supposed to lend for that long.

- TALF doesn't fit historical precedent or Bagehot's rule. A few months later, the New York Fed proposed accepting as collateral what it called legacy securities. These securities weren't newly issued and, as collateral, they weren't as safe. The expanded TALF put taxpayers at greater risk.

- Since they were putting taxpayer money at risk, an important question is: Did it work? That's hard to say, but the answer is probably yes. The funds helped some sick firms, and by some estimates, the Fed even made some money on these loans. The Fed says that it collected $743 million in TALF fees through January 9, 2013.

- Others argue that "Did it work?" is not the only question we need to ask. Expanding TALF might have been a bad idea that, luckily, happened to turn out well this time.

- *New York Times* columnist Gretchen Morgenson pointed out that there wasn't time to evaluate the costs and benefits like some officials wanted. That gives us an important lesson: Regulators need to do as much of this cost-benefit analysis as they can before the next financial crisis.

TARP

- The Troubled Asset Relief Program, or TARP, was a huge government program. John Cochrane—a senior fellow at Stanford University's Hoover Institution—lampoons the way top government officials handled TARP.

- Cochrane says that Federal Reserve Chairman Ben Bernanke, Treasury Secretary Henry Paulson, and President George Bush all went on TV and said something like this: "The financial system is about to collapse. We are in danger of an economic calamity worse than the Great Depression. We need $700 billion, and we won't tell you what we're going to do with it."

Regulators need to do as much of this cost-benefit analysis as they can before the next financial crisis.

- Cochrane says this is a perfect example of how to start a financial crisis, not stop one. Thankfully, the founders of the

Fed system set up regional banks in cities like Richmond, Cleveland, and Kansas City to counterbalance the influence of the Board of Governors in Washington DC and the money-center banks in New York City.

- Washington and money-center banks wanted to go all-in. Regional bankers in Dallas, Kansas City, and Richmond wanted to take stock of the situation first. Their economies weren't as reliant on big financial institutions, and they wanted more information before putting taxpayers at risk.

Lessons

- Cochrane offers several suggestions to make our institutional structure stronger.

- The first is to separate crisis prevention from social engineering. One cause of the 2007 financial crisis was subprime loans made to people with bad credit. Lenders had to make these loans to comply with federal law.

- Cochrane thinks that the financial crisis was a run on banking institutions. Preventing runs is a huge step toward a safer system. Cochrane thinks that we ought to restrict banking institutions from financing their businesses with short-term borrowings.

- Cochrane would like to add a safe harbor provision to the Dodd-Frank Wall Street Reform and Consumer Protection Act. This would be a way to tell the world how a bank should be financed so it isn't subject to runs. It could be short: perhaps a page. If banks adhere to those terms, then their reward is getting out from under the tens of thousands of pages of regulations they face now.

- Cochrane would like to impose a small tax, maybe 2%, on short-term financing—the kind of financing that's subject to

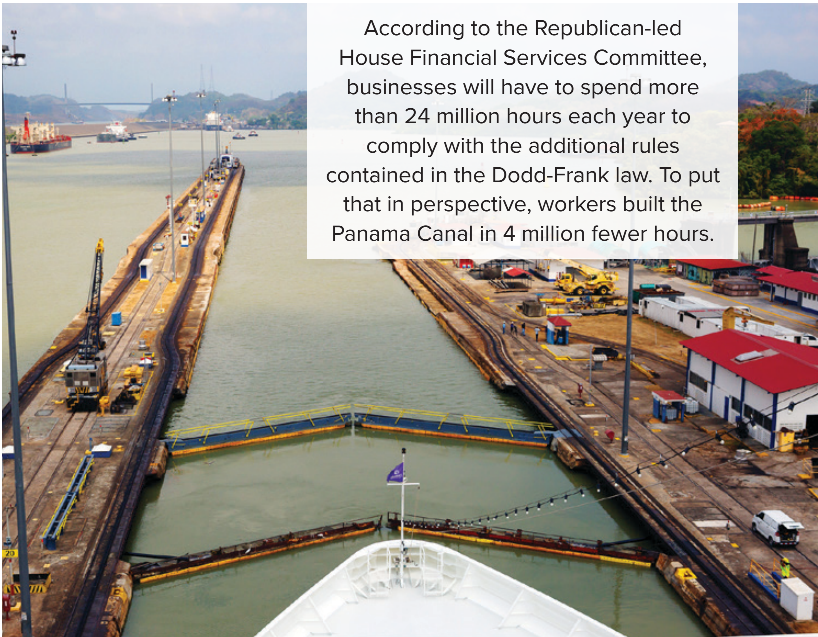
runs. If that proves to be too much or too little, then we could change it. Even in the face of a small tax, banks would use a whole lot less financing that is prone to runs.

Other Approaches

- The economist Barry Eichengreen says we need to create another international institution, which he would call the World Financial Organization, or WFO. Membership in the WFO would carry specific obligations and violating them would have substantial consequences. Of course, enforcement is the hard part.

- The WFO would set standards for supervision and regulation, such as capital requirements or internal controls. It wouldn't try to impose a specific regulatory structure.

- Eichengreen says membership would be mandatory for countries that want access to foreign markets for their



According to the Republican-led House Financial Services Committee, businesses will have to spend more than 24 million hours each year to comply with the additional rules contained in the Dodd-Frank law. To put that in perspective, workers built the Panama Canal in 4 million fewer hours.

investors and financial institutions. That's a big incentive, if you can make it work.

- Meanwhile, Durham University economist Kevin Dowd and commentator Martin Hutchinson provide a free-market approach to institutional reform in their white paper, "Learning the Right Lessons from the Financial Crisis."

- Two key points of their plan are simplifying regulations (thereby cutting down on time and money spent on compliance) and improving institutional governance (by instituting personal liability on an institution's major decision makers).

A Bad Idea

- Paul G. Mahoney, in his book *Wasting a Crisis*, states that politicians and regulators always enact more legislation in the immediate aftermath of a crisis. Mahoney says that is a bad idea.

- At that point, the politicians' and regulators' first goal is to avoid blame. When they look for a cause, they ignore any policies they enacted earlier. Instead, says Mahoney, politicians and regulators tend to pass the buck to alleged bad guys like banks or greedy people who got away with malpractice because there wasn't enough regulation.

- If we add more regulation, they say, then that'll fix things, once and for all. Mahoney calls that the market-failure narrative, which has been popular since at least the late 17th century and doesn't hold up.

- In actuality, Mahoney says, the most powerful actors—often banks or other economic institutions—are best able to influence the legislation. Mahoney states that the contemporary Dodd-Frank Act led to the biggest

commercial banks in the United States becoming even bigger and stronger.

- Mahoney *is* in favor or revising regulations over time as circumstances change, and as we learn more about their effects, but he says that should be gradual and continuous.

Have We Learned?

- The chartered financial analyst Ron Rimkus says that although officials have made some progress in improving regulations, reality keeps rearing its head.

- One might make the case that mortgage lending is back under control. But student loans have ballooned to more than $1.2 trillion, and subprime auto lending doubled between 2010 and 2015. Rimkus asks: After all we've been through, what have we actually learned?

- Walker Todd, now an adjunct scholar at the Cato Institute, would say not much, citing lax legislation enforcement. The Federal Deposit Insurance Company Improvement Act of 1991 prohibited Federal Reserve System loans to insolvent depository institutions. But during the financial crisis, the Federal Reserve made bailout loans to institutions that were either insolvent or reasonably suspected to be insolvent.

- Perhaps the biggest unlearned lesson from the financial crisis is to not believe the politicians and media pundits when they claim that they really did fix things this time around.

Suggested Reading

Allison, "Market Discipline Beats Regulatory Discipline."

Bagehot, *Lombard Street*.

Becker, "The Slow Economic Recovery." Viewed at http://www.becker-posnerblog.com/2011/06/the-slow-economic-recovery-becker.html.

Calomiris and Haber, *Fragile by Design*.

Cochrane, "Lessons from the Financial Crisis."

Dowd and Hutchinson, "Learning the Right Lessons from the Financial Crisis."

Dwyer and Lothian, "The Financial Crisis and Recovery."

Krugman, "It's Demand, Stupid."

Lewis, *The Big Short*.

MaHoney, *Wasting a Crisis*.

Reinhartand and Rogoff, "The Aftermath of Financial Crises."

Rimkus, "Three Unlearned Lessons of the Financial Crisis of 2008."

Summers, "U.S. Economic Prospects."

Todd, "Macroliquidity."

Zaring, "International Institutional Performance in Crisis."

Zarnowitz, "Business Cycles and Growth."

Questions to Consider

1. John Cochrane says that legislators should separate crisis prevention from social engineering. What does he mean by that?

2. If policymakers continue to fail to enforce existing regulations and even legislation, will reforming regulations and legislation have any chance of success? If not, then how can we hold policymakers accountable?

LECTURE 22

BANKING SUPERVISION AND THE BASEL ACCORDS

Paul Volcker—the former Federal Reserve chairman who came up with what's known today as the Volcker rule on banking regulation—wrote a 3-page memo outlining his vision to then-President Barack Obama in 2009. The goal of the Volcker rule was to keep banks from certain types of speculative investments that may have contributed to the 2008 financial crisis. By late 2013, when finalized, the Volcker rule had grown to more than 900 pages, according to Larry Wall, executive director of the Center for Financial Innovation and Stability at the Federal Reserve Bank of Atlanta. Regulations, even if they start out being simple, always end up being complex. International coordination doesn't help in this respect.

The Basel Accords

- Capital regulations on banks are an interesting case. Wall says that regulators must require banks to hold enough capital to reduce risk to acceptable levels, but regulators can't have banks raise costs enough to keep them from providing a full range of banking services.

- Around the beginning of the 1980s, supervisors decided that banks needed to meet specific capital targets. Shortly thereafter, banks began to figure out ways to circumvent those requirements.

- To resolve this, US supervisors supported a series of international agreements beginning in the late 1980s known as the Basel Accords. Basel I put all major banks on equal footing and introduced more sensitive measures of risk than previous rules.

- Banks soon complained that they couldn't compete for high-grade corporate loans anymore. They also began finding ways to get around capital requirements again. In turn, the Basel Committee on Banking Supervision produced Basel II, initially published in 2004.

- The United States took the position that Basel II was a step back for commercial banks, and didn't adopt it. But most other developed countries did. So did the US Securities and Exchange Commission for the investment banks it supervised. But banks began to get around the restrictions of Basel II shortly after.

- Next, the Basel Committee produced Basel III, taking effect in phases through 2019. No serious economist or bank regulator thinks it will be the final solution. Over time, banks—or any regulated entity, for that matter—will find ways to get around regulations. If they need help doing so, then highly competent consulting firms will be glad to help.

The Basel Committee

- Barry Eichengreen, a professor of economics and political science, calls the Basel Committee on Banking Supervision "the most prominent international institution concerned with regulatory reform" of the international financial system.

- It emerged from financial markets turmoil after fixed currency exchange rates and the gold standard collapsed in 1973. Membership currently stands at more than 24 countries, including the United States, European countries, and countries in South America and the Middle East.

- The Basel Committee meets about 4 times a year at the Bank for International Settlements (BIS) in Basel, Switzerland. It reports to an oversight body known as the Group of Central Bank Governors and Heads of Supervision.

Bank supervisors use the ratio of a bank's equity to its total assets as a measure of how safe an institution is.

- The Basel Committee's stated goal is to improve international financial and economic stability through improvements and standardization of supervision. It works to improve cross-border cooperation. That's important because most big banks have branches in multiple countries.

Authority

- The Basel Committee faces the same problem that other international economic institutions face: It has no legal authority, and can only *recommend* action. For example, the United States didn't fully implement Basel II.

- The committee does have stature among the international community, though. Because a big majority of members sign on to the committee's standards, the remaining countries face international pressure to get on board, too.

- Here's an example of the Basel Committee in action: During the Latin American debt crisis in the 1980s, major international banks were adding more and more debt, with less and less equity backing it.

- Bank supervisors use the ratio of a bank's equity to its total assets as a measure of how safe an institution is. Capital ratios for major banks were deteriorating as it became apparent that Latin American countries were in no position to repay some of the loans the banks had made.

- The Basel Committee decided on a system of risk weights to ensure that capital levels were adequate. Safe assets didn't need much capital backing them. Riskier assets required more capital to support them.

- The Basel Capital Accord was approved in July 1998 by what was then known as the Group of 10—or the G10 group. These are large, industrialized nations. The accord set a minimum risk-weighted capital ratio of 8% that ultimately was introduced not only in member countries but also in virtually all other countries with active international banks.

- Nobody expected this to be the last word on capital. It was just the next step in the regulatory dance.

- June 1999 brought forth the proposal known as Basel II. The impetus was the international banking industry's increasing success at getting around the capital standards of Basel I.

- Basel II brought a more sophisticated approach to the risk-weights of various asset classes. Member nations agreed to adopt the proposal, but not all agreed to implement them at the same time. That made coordination during the initial phase more difficult.

Basel III

- The Basel Committee didn't like what it saw in the months prior to the financial crash of 2007–2008. Banks were carrying too much debt to suit the committee. Bad governance and bad incentives were leading to too much

bank borrowing and too much easy credit from banks to borrowers. Risk pricing was also a problem.

- That prompted the next step in the regulatory dialectic. By December 2010, what's now known as Basel III was approved, though it would take years to roll out. This accord featured higher capital requirements and long-overdue, tightened recommendations for handling new securities, affiliates, and banks' securities trading.

- The reason that implementation was spread over many years—up to 10—arises from the complexity of international regulation. It also reflects the need for participating nations to enact responsive legislation. Remember, the Basel Committee doesn't make law. It just sets standards and rules. Members nations themselves must enact the laws to give these the Basel Committee's recommendations teeth.

- Part of the delay also reflects a desire to avoid slowing the international economy too much. This is a problem with regulation. Regulations constrain behavior, and some of that behavior might be economically profitable.

- Meanwhile, the United States implemented bank stress tests, which try to predict what would happen under different harmful scenarios. These stress tests take Basel as a starting point.

- Basel III—like its predecessors—relies on accounting data that's old the moment after it's produced. It might still be accurate, but the older the data, the more likely it's misleading. Why take the chance if you know a way to supplement your knowledge about risks? Stress tests offer that.

- Another problem with Basel III is that it relies on so many estimates. Some larger banks could have around 200,000 different risk classifications. Some of those estimates will be wrong, or even have outright errors.

- Larry Wall of the Federal Reserve Bank in Atlanta says Basel III covers a wide range of possible outcomes, but it casts a very dim light. Stress tests, by comparison, cast a very bright light. The tradeoff is that they only illuminate one scenario. Using both types of light is better than just one.

- Stress tests share a serious flaw with Basel III: Both ignore interest-rate risk. If interest rates increase, particularly for long-maturity loans, then banks suffer large losses that could threaten their survival. Stress tests can be designed to check this, but they don't always do it.

Dodd-Frank

- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was arguably the biggest financial bill since the Depression. The goal of its sponsors was to prevent—once and for all—crises in the financial sector.

- One reason: During the financial crisis regulators gave massive financial assistance to prop up failing and weakened institutions. An unusual amount of assistance went to firms that weren't even banks. American International Group, an insurance company better known as AIG, was the poster child of the bailout.

- AIG and a few other institutions were defined as systemically important. That means that they were too important to the entire US financial system to be allowed to fail. The common moniker is "too big to fail." The problem: The government's bailing out of too-big-to-fail institutions leaves taxpayers with the bill.

The United States implemented bank stress tests, which try to predict what would happen under different harmful scenarios.

- The Federal Reserve Bank of St. Louis says that a big goal of the Dodd-Frank Act was to identify and supervise these systemically important institutions and to eliminate too big to fail. That's even though, under the law, banks and bank-holding companies with more than $50 billion in assets are automatically classified as systemically important.

- Dodd-Frank also established a new regulatory body, the Financial Stability Oversight Council. Under Dodd-Frank, large financial institutions and others designated by the Financial Stability Oversight Council for supervision must periodically submit "living wills" identifying how they would resolve their affairs should they fail.

- Forrest Stanley, the lead lawyer in KeyBank's initial living-will submission, says the rule has failed to achieve its goal of providing workable strategies for rapid and orderly resolution of financial institutions. He says he believes it's "impossible to create a plan that effectively anticipates all of the 'unknowables' of the next crisis."

- At the same time, Mr. Stanley says the living-will rule has produced some benefits. Institutions have been forced to simplify their corporate structures, which will make resolutions easier. Also, he says the plans have provided regulators with a deeper understanding of each financial institution's businesses and vulnerabilities.

Banks and bank-holding companies with more than $50 billion in assets are automatically classified as systemically important.

- One nice provision of Dodd-Frank gives the Federal Deposit Insurance Corporation the authority to intervene if it—along with the Federal Reserve and Treasury—believes that an institution is in serious trouble. Before Dodd-Frank, the FDIC got involved only after the closing of a bank.

- This provision would be a lot more attractive if we could be convinced authorities would use it. The Federal Deposit Insurance Corporation Improvement Act of 1991 already gave regulators the authority to take "prompt corrective action" if banks got in trouble. However, it didn't work very well because when push came to shove, regulators did not act earlier and more aggressively.

LIBOR

- Former Morgan Stanley bond and derivatives trader Douglas Keenan wrote an article in the *Financial Times* titled "My Thwarted Attempt to Tell of Libor Shenanigans." In it, Keenan described his experience in trading futures contracts based on what has been described as the world's most important interest rate; that is, the London Interbank Offered Rate, or LIBOR.

- The value of those contracts depended on the LIBOR at a predetermined time. Keenan noticed that his contracts settled at the wrong rate. He was looking at live trading screens that showed one rate, even though the contract settled a few hundredths of a percent away from that. That cost him money, and he complained to the London International Financial Futures Exchange.

- The exchange replied that it was doing exactly what it was contracted to do. Instead of settling contracts at actual rates, it settled them by taking a survey of a few banks. The exchange discarded the highest and lowest rate, and averaged the rest to find the settlement rate.

- Banks lied in ways that made it more likely that they'd make more money. They were colluding to manipulate the rate. These false rates also misled supervisors into thinking that certain banks were safer than they really were. If they were

able to borrow at a low rate, then they had to be pretty safe, right? That would be true, if the rates were accurate.

- Regulators did conclude that banks had been manipulating the LIBOR rate. Aside from the problems of defrauding market participants, such manipulation undermines the credibility of the international economic system. If people believe that prices are rigged, then markets can break down.

- The Financial Stability Board—an international regulatory body—produced a lengthy report in July 2014. A central recommendation was that posted reference rates like LIBOR should, whenever possible, reflect actual market transactions.

- A second recommendation was to develop alternative benchmark rates. The idea behind that is to allow market participants to use the rate that they view as most trustworthy for their transactions.

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Questions to Consider

1. Why do policymakers consider some institutions too big to fail?
2. Will banking regulation ever be done right, once and for all? Why or why not?

LECTURE 23

A UNIFIED EUROPE, AND THEN BREXIT

The European Union (EU) today is an economic powerhouse encompassing almost 30 nations—and more than 500 million residents—in an area about half the size of the continental United States. It produces more than 22 percent of the world's output, with about $16.5 trillion dollars in nominal gross domestic product, according to the International Monetary Fund. That means that the average resident of the European Union is 3 times richer than the average resident of the planet Earth. And according to *Fortune* magazine's Global 500 list, about 160 of world's largest corporations are based in the European Union. That so many nations could develop what amounts to a single market is amazing.

Accomplishments

- The European Union has gone even further than free trade. It created a single market by standardizing the laws that apply to commerce within the political and economic union, with headquarters in Brussels.

- These laws are designed to guarantee 4 freedoms: the free movement of goods, services, capital, and people. Throughout the territories of the 25 or so nations that officially abolished border controls for union members, EU residents don't even need a passport.

- The EU has developed a large bureaucracy to administer it. At the helm is the European Council, established in 1975 and consisting of the heads of state of member countries, and the European Parliament, formed in 1979. The European Council describes itself as defining "the general political direction and priorities" of the EU, while the European Parliament is the lawmaking body, and maintains "legislative, supervisory and budgetary responsibilities."

- Additionally, there's the European Commission, which manages the daily business of the EU. It draws up proposals for legislation, and "implements the decisions of the European Parliament and [yet another body known as] the Council of the European Union."

- The Council of the European Union—describes itself as the "voice of EU member governments, adopting EU laws and coordinating EU policies" under the leadership of government ministers from each EU country.

- Alongside the European Union's executive, legislative, and administrative bureaucracies are courts and a central bank. The Court of Justice of the European Union plays a role similar to that of the US Supreme Court. It makes sure that national courts interpret certain legal issues consistently throughout the EU. The European Central Bank is the EU's equivalent of the Federal Reserve System in the United States.

Cooperation

- The Eurozone—a term that refers to the European Union's monetary union of 19 states, where the euro circulates as the official currency—has been, since it was formed in 1998, one of the largest single-currency regions in the world.

- EU residents can travel for business or pleasure without worrying about passports. That also means that services flow freely across national borders. Within the Eurozone, the need for currency conversion disappears, as well.

- Such close cooperation extends to many other issues, such as anti-terrorism efforts and countering drug trafficking or

Internet crime. Being part of the European Union means that each country faces the rest of the world as part of a much more powerful organization.

Drawbacks

- With EU membership comes many regulations and other requirements—even though not all of them trace directly to the EU.

- The EU has no fewer than 23 official languages. Abandoning the EU wouldn't reduce the number of languages. But it would reduce the number of times that a document must be translated. It also would eliminate the potential, if minor, insult of designating some languages—specifically English, French, and German—as "working" or "official" languages at the expense of others.

- The EU's Working Time Directive is another example of a regulation that offers some benefits while imposing costs that probably outweigh them. Its stated purpose is to protect people's health and safety by preventing people from working more than 48 hours a week. It also stipulates a minimum daily rest period of at least 11 consecutive hours every 24 hours.

- Drawbacks to this include higher costs to businesses and higher prices for consumers, as well as reducing workers' opportunities.

Immigration

- Across the EU, a contentious issue is immigration. Thanks to the Schengen Agreement, someone who enters Greece legally can travel without bothering with passports or other checks all the way to Spain or Sweden. That means

that Spaniards and Swedes must trust Greek immigration controls, and vice versa.

- That doesn't sit well with citizens of some EU nations. Hungary, for instance, laid razor wire along its southern border, and European Union leaders also developed plans to destroy smugglers' boats off the coast of North Africa.

- A Schengen Area member country retains the right to reinstate full border controls. But to do so, it must declare a threat to national security, such as disease or suspected terrorist activity.

Robert Schuman and Jean Monnet

- Following World War II, the French statesman Robert Schuman and diplomat Jean Monnet conceived of a united Europe as means to prevent future wars. In 1947, Schuman became France's prime minister. Among Schuman's most notable legacies was to propose a new governmental structure for all of Europe, initially in the form of the Council of Europe, founded in 1949.

- Monnet would come to extend Schuman's vision considerably. Monet was the driving force behind the historic Schuman Declaration of May 9, 1950, to place Franco-German coal and steel production under one authority.

- This led to the creation of the European Coal and Steel Community, which was initially formed by France, Belgium, Italy, the Netherlands, Luxembourg, and West Germany. It eventually would lead to the creation of the European Union. Monnet was the organization's first president, a position he held until 1955.

- In March 1957, the member nations of the European Coal and Steel Community signed the Treaty Establishing the

European Economic Community, more commonly known as the Treaty of Rome. Taking effect in January 1958, the treaty created a common market to be known as the European Economic Community. It also established a customs union.

- The 1960s brought joint control over food production, and in the 1970s, the EU ramped up its environmental efforts, passing laws to protect the environment.

- In 1973, the community expanded to nine with the addition of Denmark, Ireland, and the United Kingdom. However, the Arab-Israeli war of October 1973 caused severe energy and economic problems in Europe.

- On the positive side, the last right-wing dictatorships lost their grip with the end of the Salazar regime in Portugal in 1974 and General Franco's death in Spain in 1975. The EU began to transfer huge levels of aid to poorer regions of the EU in attempts to create jobs and to build infrastructure.

- Polish trade union leader Lech Wałęsa became known around the world following the Gdansk shipyard strikes during the summer of 1980. Greece joined the EU in 1981, followed by Spain and Portugal in 1986.

A Schengen Area member country retains the right to reinstate full border controls. But to do so, it must declare a threat to national security, such as disease or suspected terrorist activity.

- Also in 1986, the EU enacted the Single European Act. This treaty provided the foundation for a huge, 6-year program designed to identify and resolve problems with enacting free trade across EU borders—the precursor to the single market.

- The Maastricht Treaty formally established the EU upon taking effect on November 1, 1993. The treaty also

established the Euro currency, effective on January 1, 1999. Even then, the Euro was not a physical currency. Euro notes and coins weren't introduced until 3 years later.

- Austria, Sweden, and Finland joined the EU in 1995, raising the number of member nations to 15, and 10 more entered in 2004. This expansion marked a change, as not all new member states were modern, Western European nations. They included Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia.

A big problem with implementing free-trade policies is the domestic political pressure arising from special interest groups.

- Romania and Bulgaria joined the EU in 2007, and Croatia became the 28th member in 2013. The EU established a new joint security policy after Russia annexed Crimea.

Stopping Protectionism

- Tufts University economist Enrico Spolaore says that the drive to integrate Europe after World War II wasn't exclusively about preserving the peace. Stopping protectionism was also a factor.

- A big problem with implementing free-trade policies is the domestic political pressure arising from special interest groups. Think of steel producers or agricultural groups, for example. They don't want to have to face foreign competition.

- An international economic institution such as the European Union gives political cover to domestic politicians, who can tell their constituents that they have no choice but to open their markets.

Brexit

- No discussion of the EU would be complete without addressing Britain's vote in June 2016 to leave the EU. Brexit quickly spawned talk of other nations leaving, too.

- Some supporters of remaining in the EU boiled down the arguments of the pro-Brexit forces to one thing: immigration. On the other side of the argument, pro-Brexit forces boiled down the arguments of the anti-Brexit forces to one thing, too: national sovereignty.

- But exiting the EU has implications that simply can't be boiled down to one thing. British researchers Angus Armstrong and Jonathan Portes say that even if the UK could maintain free trade with EU member states after leaving, it wouldn't be the same. They point out that free-trade agreements "do not cover all services," and that "there is no region in the world which has such a high level of integration of services across sovereign borders" as in the EU.

- Geopolitical analyst George Friedman says that Germany, not the United Kingdom, might have the most to lose from Brexit. Free trade is the most fundamental aspect of EU membership, and that Germany derives almost half of its GDP from exports, with much of that going to the United Kingdom. Even a 5% decline in exports would cut Germany's GDP by 2.25%, Friedman calculated.

- Peace is another issue. As the specter of Brexit changed the geopolitical calculations for Great Britain, former British Prime Minister David Cameron was quoted as saying: "Can we be so sure peace and stability on our continent are assured beyond any shadow of doubt? Is that a risk worth taking? I would never be so rash to make that assumption."

- Some EU rules have unintended consequences. Cambridge University law professors Catherine Barnard and Amy

Ludlow cite the example of the Treaty on the Functioning of the European Union. They note that the treaty prohibits discrimination in interstate situations. However, intrastate discrimination does not fall under EU law.

- This lets Scotland offer free higher education to Scottish and EU students, and withhold it from students from England and the rest of the United Kingdom. One can understand why Scottish universities might want to provide free education to students from outside of the UK—but within the EU—based on merit. But there isn't a good reason for a blanket policy of funding them while excluding UK students.

Sovereignty Issues

- As a member of the EU, how much of Great Britain's law comes from Brussels, rather than its own parliament and people? Most estimates range from 14% to 17%.

- In the leadup to the Brexit vote, *New Criterion* editor Roger Kimball fanned frustrations with his report that the EU was set to crack down on toasters, hair dryers, and electric tea kettles because some nameless bureaucrat in Brussels has decided they are not sufficiently "green."

- Kimball said Brexit was about British sovereignty. Brits, he contends, can make their own decisions about items that affect their lives. The emphatic result of the Brexit vote affirmed the will of British citizens that such decisions should be made through their duly elected representatives in Parliament, and not in Brussels.

- Financial markets plunged on the initial news of the Brexit movement's victory. US stock futures dropped about 600 points at first, but recovered to record highs soon after. Europe's stock markets suffered even deeper losses, but those markets also recovered quickly. To investors, Brexit

looked to have been a less traumatic economic event than initially thought.

- Tufts University's Enrico Spolaore has followed the course of European integration through history, and refers to it as being "a sort of chain reaction towards an 'ever-closer union.'" He concludes that despite the EU's serious limitations, as reflected in the Brexit vote, it nevertheless remains the most ambitious and successful example of international cooperation in history.

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Questions to Consider

1. The European Union was designed to prevent another war on the European continent, and to lead to a United Europe. Do you think that the EU deserves credit for war being averted so far?
2. Do you think that the European Union has expanded too much? If so, then how can it shrink with the least possible economic damage?

LECTURE 24

THE G-ZERO ERA OF INSTABILITY

The Great Recession was much like an echo of the Great Depression. The causes weren't exactly the same, but we did see some of the same responses: new regulatory institutions and the expansion of existing ones. We saw that political responses had mixed success in response to crises, but political bodies, rather than economic ones, emerged as the forum for crisis management. This lecture turns to the G groups, which are purely political entities.

The G Groups

- Among the G groups are the Group of Seven (G7), the Group of Eight (G8), the Group of 20, and a few others. The G7 is the most exclusive, composed of the United States, the United Kingdom, and Canada, France, Germany, Italy, and Japan. They meet each year to discuss topics like energy, security, and global economic governance.

- It's important to recognize these working groups—or affiliations—have no formal standing. They are political

organizations that meet when and where they want to meet, at their sole discretion.

- The economist Barry Eichengreen argues that the G20—representing about 80 percent of global economic output—nevertheless has a legitimacy problem. He notes that the membership was formed "essentially in ad hoc fashion" at the end of the 1990s. Nobody appointed these countries to make decisions for the rest of us, and nothing ensures that their recommendations will be respectfully received and followed.

- So why treat them as international economic institutions? The answer is that the G groups have had some success in dealing with economic crises.

- Keeping track of the G groups is difficult because there are a lot of them, and their composition changes over time. The original G6 met in a French chateau south of Paris in 1975 to discuss the oil crisis and an earlier decision by President Richard Nixon to leave the international gold standard.

- Representatives of 6 governments attended: France, West Germany, Italy, Japan, the United Kingdom, and the United States. Canada joined the next year, so the group became the Group of Seven, or G7. In 1981, the European Union became the eighth member of what would still be named the G7.

- The G7 doesn't have any formal criteria for membership, other than being an economically powerful democracy. The stipulation about being an economically powerful democracy explains the treatment of Russia, which joined the G7 in 1998, giving birth—at least temporarily—to the G8.

- At the time, US president Bill Clinton thought that admitting Russia to the G7 would allow Russian president Boris Yeltsin to draw closer to the West. Some members of the G7 opposed this move. Russia wasn't a good match for the G7. It was economically weak and had a large public debt relative

to its economy. Its foreign policy didn't match well with the G7, either, and its democratic roots—such as they were—were shallow.

- Initially, the big disagreement on foreign policy within the new G8 was Russia's opposition to its former Eastern European satellites joining the North Atlantic Treaty Organization, or NATO.

The G7 doesn't have any formal criteria for membership, other than being an economically powerful democracy.

- Under Vladimir Putin, Russia began to slide back toward totalitarianism. Russia annexed Crimea—and supported an invasion of Ukraine in 2014. The G8 dismissed Russia as a member under the Hague Declaration of March 2014, and the organization reverted to the G7.

The G20

- The biggest, most visible of the G groups is the G20. It began meeting in late 1999, in response to the global financial crisis that had torn through Asia, Russia, Europe, and United States 2 years earlier.

- The University of Toronto's John Kirton explains that the mandate of the G20 is to "promote discussion and study and review policy issues among industrialized countries and emerging markets with a view to promoting international financial stability."

- Unlike the European- and North American–centric G7, the G20 encompasses a much broader membership, from Asia to the Americas and Africa. Member countries include China, India, South Korea, Australia, Brazil, Argentina, and South Africa.

- Thomas Wright, director of the Project on International Order and Strategy at the Brookings Institution, says the G20's finest hour might have been in responding to the financial crisis of 2007 and 2008.

The G20 lined up about $5 trillion in a fiscal stimulus and formed a new international oversight body called the Financial Stability Board, or FSB.

- G20 summits in Washington and in London in 2008 and 2009 went a long way toward averting a second Great Depression, according to Wright. He says "unprecedented" cooperation among major world economies limited the spread of the banking crisis by providing liquidity that kept markets open. It also kept countries from turning to protectionism after the initial crisis passed.

- The G20 lined up about $5 trillion in a fiscal stimulus and formed a new international oversight body called the Financial Stability Board, or FSB.

- After the world economy had stabilized a bit, disagreement took the place of consensus. Germany and Britain favored restraint—a policy that's now called austerity. The United States headed a group that wanted more government spending.

- Though different opinions are not necessarily a bad thing, the G20 was no longer influencing state-level decisions very much. In any case, the G20 did seem to get the immediate response to the financial crisis right.

The G7 in Action

- During a conflict between Russian-backed rebels and Ukraine in 2014, G7 leaders tried to isolate Russia with

economic sanctions. But G7 leaders couldn't agree on how severe the sanctions should be, or who—or what—should be the target of those sanctions.

- The United States wanted to target state officials, pro-Russia separatist leaders, and several Russian businesses and businessmen. The European Union, which trades more with Russia than the United States does, agreed to target state officials and separatist leaders, but didn't want to damage trade by extending sanctions to businessmen.

- Understandably, the disagreement led to some dissension among G7 representatives. Germany had reason for concern: In this example, Russia could respond to sanctions by cutting off natural gas supplies to Germany. As with trade wars, both sides lose, and it's not always clear which side suffers more.

- James Goldgeier, the dean of American University's School of International Service, says that Russia never belonged in the group in the first place. He says Russia doesn't share the same views on democracy, human rights, and expansionism as the other G7 members. Other opportunities for engagement with Russia already existed through the United Nations and the UN Security Council.

G7 Problems

- Council on Foreign Relations senior fellow Stewart M. Patrick says that "Russia, lacking both an advanced economy and a robust democracy, was always the odd man out." This was a problem long before the Ukraine crisis, he adds.

- Patrick also contends that the G7's sanctions of Russia were mostly symbolic. They didn't influence Russian president Vladimir Putin's behavior very much.

- Meanwhile, Russia still had plenty of other diplomatic channels through which to work. The G20—a much more expansive and diverse group—"is where Russia belongs," Patrick contends.

- Some forecasts for the G7 were not particularly bright back in the early 1990s. Princeton University professor of international relations John Ikenberry published a piece in *Foreign Affairs* titled "Salvaging the G-7." To Ikenberry, the G7 is "a reactive accumulation of consultations that usually springs to life only once a crisis has begun."

- When the G7 does reach an agreement absent a crisis, it seems consistent with political posturing. Take the 1978 Bonn summit, for example. The United States agreed to decontrol domestic oil prices if Germany and Japan would try to increase their domestic inflation rate. Britain and France said they'd try to resolve an impasse in the ongoing talks on the General Agreement on Tariffs and Trade.

- That just boils down to G7 leaders promising to do things that they would probably have done anyway, Ikenberry says. After a G7 summit, however, these leaders could tell their domestic constituents that they'd talked tough with foreigners and accomplished something. That strengthened them against domestic opposition.

> *When the G7 does reach an agreement absent a crisis, it seems consistent with political posturing.*

- Ikenberry believes that G7 member countries haven't been able to make what he calls "hard economic choices" at home to deal with slow growth, unemployment, or unstable governing coalitions. Those problems should—and do—take priority over international cooperation. Ikenberry suggests that nations should make those hard choices to resolve those problems, so that international cooperation can proceed.

G-Zero

- Eurasia Group president Ian Bremmer has coined the term G-Zero to describe a world in which no single nation has enough power to take the lead in fostering international cooperation, leaving a power vacuum.

- Bremmer and economics professor Nouriel Roubini contend that the larger G groups of leading economies have "gone from a would-be concert of nations to a cacophony of competing voices as the urgency of the financial crisis has waned and the diversity of political and economic values within the group has asserted itself." Once the crisis passed, domestic political and economic priorities reasserted themselves.

- Who or what can step into the power vacuum? Bremmer and Roubini rule out the United States, saying that it lacks the resources to do the job. Europe has its hands full with economic problems within the Eurozone. Japan has faced slow growth for decades. And all 3 lack the political will to allocate massive resources to the international arena.

- Meanwhile, emerging powers such as China, India, and Brazil seem to be too focused on their own development to assume the financial burdens of international economic leadership.

- The G20 itself is beset by divisions, Bremmer contends. He says the members of this group do "not share a common set of assumptions about the proper role of the state in an economy, or about the value of the rule of law, transparency and freedoms of speech, press and assembly." Competing values create competing interests. These competing interests hinder cooperation, weakening the influence of the G20.

- Bremmer and Roubini both say: "We are now living in a G-Zero world, one in which no single country or bloc of countries has

the political and economic leverage—or the will—to drive a truly international agenda."

- They predict that "the result will be intensified conflict on the international stage over vitally important issues." They list economic matters such as international macroeconomic coordination, financial regulatory reform, and trade policy. They also cite topics without a direct economic link, such as climate change.

- Any such frictions have serious implications for the global economy. But Bremmer and Roubini say that investors hoping for political and economic uncertainty to pass can expect a long wait.

Institutions

- During this course, we've seen how these institutions form and how they operate. We'd like to think of international political and economic institutions as being wise and benevolent, somehow transcending human nature. Instead, we found that—like any other human institution—they have their warts. Politics often takes the spotlight.

- Nations do join together to pursue lofty goals, and they do strive to cooperate in reaching them. Yes, they do have their successes. But we also learned that domestic politics always trumps international cooperation.

- We learned that international political and economic institutions are large bureaucracies, filled with normal people. They are subject to mission creep, red tape, inertia, and a host of other problems.

- It's doubtful we'll see dramatic change any time soon. That's because people won't change any time soon. Politicians and

leaders of international institutions are human, with human failings.

- That doesn't make them bad. On balance, they and the institutions they operate are often helpful. Just remember that these institutions aren't infallible.

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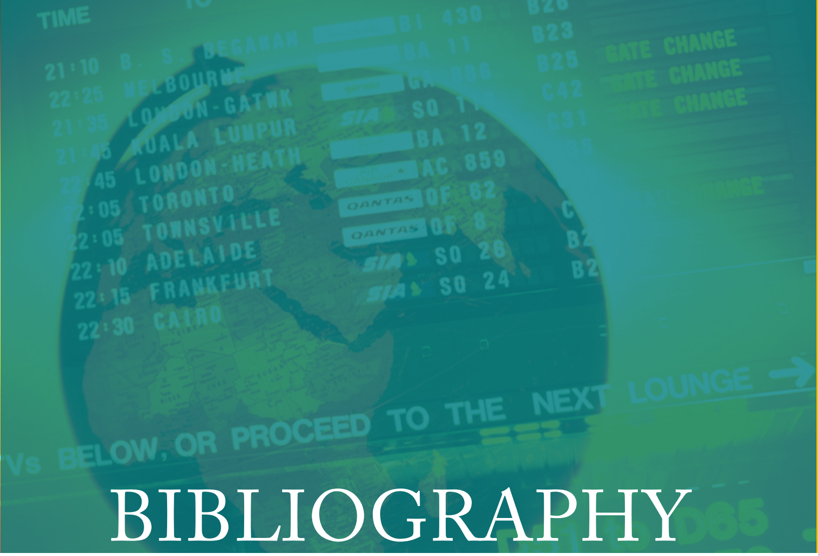
Questions to Consider

1. Unlike the International Monetary Fund or the Bank for International Settlements, the G-groups lack a formal institutional structure. Do you see this as a strength or a weakness? Do you think that the difference in structure traces to the G-groups being political institutions rather than economic institutions?
2. What might be the implications of a G-Zero world?



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